B 6785-1

northwest economic
indicators
NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Fall 1981 Regional Economic Survey

November 4, 1981

Highlights

- **Along with high interest rates and depressed farm income, pessimism abounds in the region's farming areas. Most agricultural bankers expect economic conditions to either deteriorate or remain flat at least through the first half of 1982. Even so, economic conditions vary considerably throughout the region.**

- **The economic stress is being felt on main street. Sales are down and profit margins are becoming very thin. Most bankers anticipate farmers will continue to forestall major purchases and improvements. Capital expenditures will be held to the bare necessities.**

- **Despite this gloomy outlook, a number of factors suggest that crop prices are near their low point. These include opening the government grain reserve to 1981 crops, the poor Soviet harvest, dry weather in Australia and Argentina, and an expected surge in U.S. agricultural exports.**

- **Although increasing moderately during the past six months, farm loan demand remains sluggish at most banks in the region. Weak loan demand is expected to prevail well into next year. Although some heavily indebted operators face a real bind, overall quality of credits remains high.**

- **Rural areas are more closely tied to the national business cycle than before. The advent of the six-month money market certificate in mid-1978 is the major factor behind this change. Since that time, interest rates charged by country banks have become much more responsive to swings in the national money market.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

- **A slowdown in economic activity is evident in the Twin Cities. Most bankers anticipate a sluggish 1982, unless interest rates come down substantially. Nevertheless, due to anticipated strong growth in high technology and service industry employment, the Twin Cities economy is projected to outperform the rest of the state. Meanwhile, heavy layoffs in the taconite industry have crushed the hopes for continued improvement in the Minnesota Iron Range area.**

- **While increasing during the past six months, loan demand remains sluggish at both Twin Cities and Iron Range banks. Moreover, loan demand is expected to decline during the next six months, with the weakness being the most pronounced at Iron Range banks.**

Our eleventh semi-annual survey of bankers in the Upper Midwest and the Great Plains reveals that gloom has returned to the Region. Economic conditions are expected to be weak throughout much of 1982, especially during the first half of the year.

The projected economic slowdown is widespread, encompassing most agricultural communities, the Iron Range and the Twin Cities. Nevertheless, as indicated by the Regional Confidence Index (shown inside), the outlook is not as gloomy as during the Spring of 1980, when the nation and our region were jolted by a steep economic downturn. Although the index from the Iron Range suggests that economic conditions will remain the same or improve slightly during the next six months, this is not an indication of strength. As one banker put it, the outlook still is not good, but merely better than very poor conditions existing last year.

This picture emerges from survey responses from over 650 bankers located in the Twin Cities, Minnesota's Iron Range and agricultural communities in Iowa, Minnesota, Montana, Nebraska, North and South Dakota and western Wisconsin. The survey was conducted in late September.

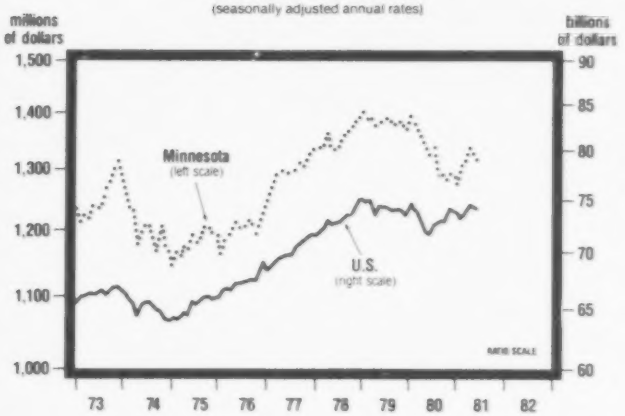
Economic Conditions

Agricultural Communities: Pessimism prevails in the region's farming areas. Most agricultural bankers expect economic conditions to either deteriorate or remain flat at least through the first half of next year. The pessimism stems from depressed farm earnings and continued high interest rates.

REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME

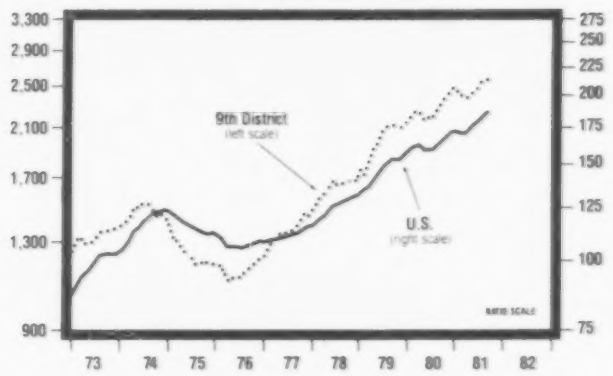
(seasonally adjusted annual rates)



COMMERCIAL AND INDUSTRIAL LOANS

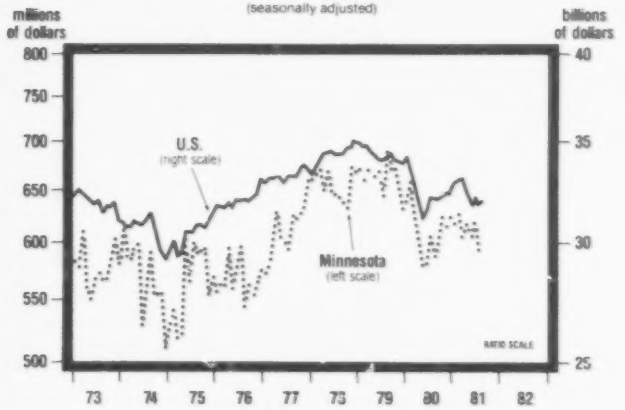
OUTSTANDING AT LARGE COMMERCIAL BANKS

(seasonally adjusted annual rates)



REAL RETAIL SALES

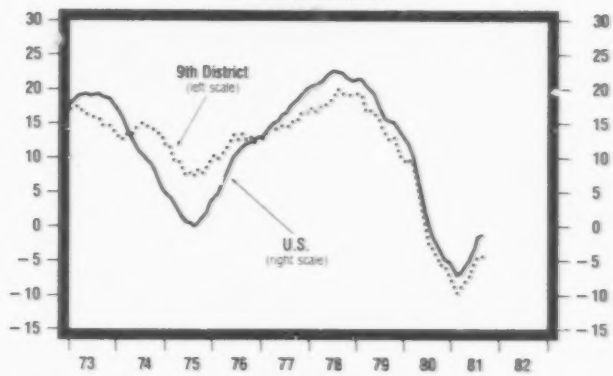
(seasonally adjusted)



CONSUMER INSTALLMENT CREDIT

OUTSTANDING AT COMMERCIAL BANKS

percent change from a year ago

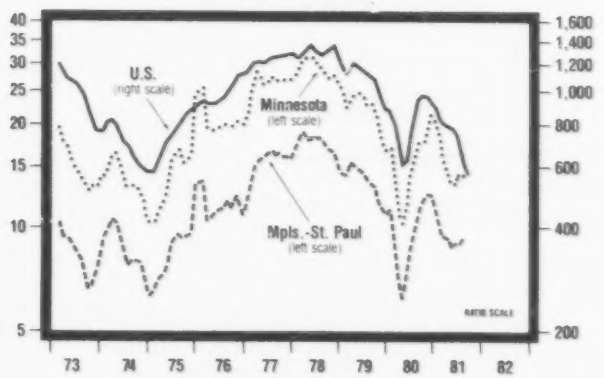


HOUSING UNITS AUTHORIZED

BUILDING PERMITS FOR 1-4 FAMILY UNITS

(seasonally adjusted annual rates)

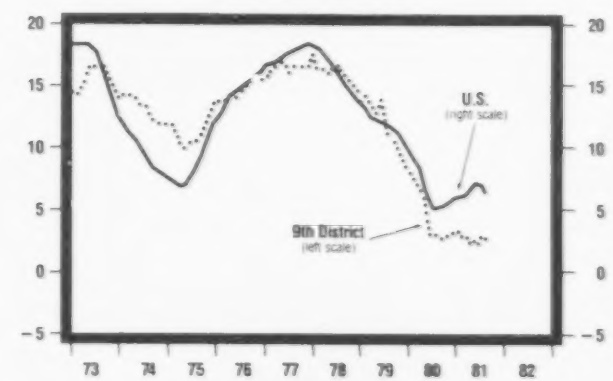
thousands of units, 3-month moving average



MORTGAGE LOANS

OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS

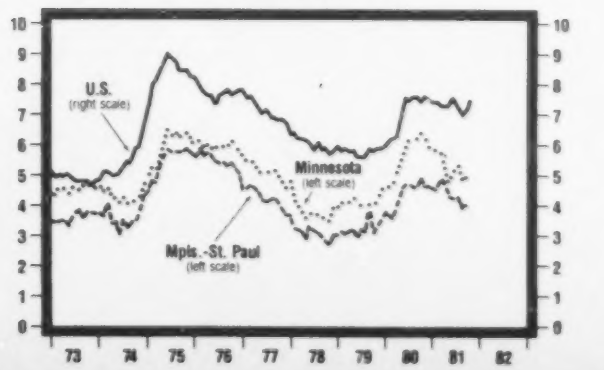
percent change from a year ago



UNEMPLOYMENT RATES

(seasonally adjusted)

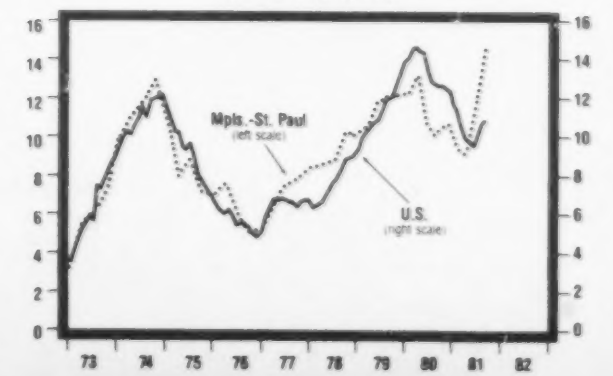
percent of labor force



CONSUMER PRICE INDEX

ALL ITEMS, ALL URBAN CONSUMERS

percent change from a year ago



Real farm income in 1981 is expected to fall short of depressed 1980 levels. Moreover, initial prospects for 1982 are not promising as bumper U.S. crops weigh heavily on prices and the chances of any strong rebound in farm earnings. The ripple effects will continue to be felt by a broad range of businesses in rural communities.

Besides coping with unprofitable cattle prices, farmers are being squeezed by depressed crop prices and rising production costs, with fuel, fertilizer and interest expenses leading the way. To further complicate matters, some parts of the region have also recently experienced severe drought or other weather-related problems.

Although pessimism is prevalent almost everywhere, current conditions and the prognosis for the year ahead vary greatly throughout the region. Economic conditions tend to be the weakest in South Dakota, Montana and portions of North Dakota.

Prior to the most recent bout of bad economic news, many farmers and ranchers in these localities were already suffering from last year's poor harvest. In some instances, drought conditions have extended over a three-year period. At the present time, lack of moisture is a concern in eastern Montana, southwestern North Dakota and a significant portion of South Dakota.

The depressed state of the lumber and wood products industry is also weakening the Montana economy. The same is true for parts of Minnesota and Wisconsin.

On the other hand, oil and gas exploration in the Williston Basin is offsetting depressed farm conditions in portions of North Dakota and eastern Montana. Oil income from both leases and production is expected to continue to stimulate overall economic activity in that area. However, conditions are expected to be rough on farmers and ranchers not receiving this mineral supplement.

Bankers indicate that conditions in the Red River Valley and parts of North Dakota have improved from the depressed state resulting from last year's drought. Yet, business activity is expected to improve very slowly during 1982.

Weak economic conditions have also spread to the previously stronger portions of the region which included central and southwestern Minnesota, Iowa, Wisconsin and parts of Nebraska. Nevertheless, economic conditions are still not expected to be as weak as those prevailing elsewhere. While farm earnings will decline in these localities, excellent crop yields will soften the impact of poor market prices.

In addition, although the honeymoon appears to be over, the dairy sector is still expected to provide stability to portions of Minnesota and Wisconsin. Established dairy farmers are expected to expand herd size to maintain cash flow. Lower feed costs this year will also help offset reduced dairy price supports.

The ramifications of continued weak farm income are far-reaching. Over 80 percent of the bankers reported that capital expenditures by farmers are lower than a year ago. Moreover, agricultural bankers anticipate that low farm earnings and high interest rates will continue to forestall major purchases and improvements by farmers. A number of bankers stated that capital expenditures will be held to the bare necessities.

Weak farm income and high interest rates continue to take their toll on merchants in farming communities. According to one banker, "The economic stress is being felt on main street. Sales and profits are down." Most bankers foresee little relief for machinery and vehicle dealers. The housing market is also expected to remain depressed until long-term interest rates reach a more reasonable level.

Bankers also report softening land prices in response to lower farm income. About 65 percent of the bankers said land prices were unchanged from a year ago. Another 10 percent reported land prices were lower than a year ago.

About 45 percent of the agricultural bankers expect overall economic conditions to deteriorate in their communities during the next six months. Only 10 percent expected conditions to improve. Lower interest rate and higher commodity prices were seen as the key ingredients to improved economic conditions. Bankers, particularly in Iowa, Minnesota and Nebraska, felt the outlook for their areas would be good in 1982 if crop prices came back into line. However, only 10 percent of the agricultural bankers in the region actually expected any improvement in farm income during the next six months.

Despite this gloomy outlook, a number of factors suggest that farm commodity prices are near their low point. These include opening the farmer-owned grain reserve to 1981 crops, the poor Russian harvest, dry weather conditions currently reported in Australia and Argentina and an anticipated pick-up in U.S. agricultural exports. A number of bankers reported that farmers plan to hold grain until prices improve. They anticipate farmers will place considerable amounts of corn under CCC loan, thereby avoiding sales at depressed harvest season prices.

The outlook for livestock producers is also clouded. Aided by lower feed costs, 1982 earnings of feedlot operators are expected to exceed depressed levels existing during most of 1980 and the first half of 1981. Yet, the livestock economy will not be restored to complete health.

Following losses during much of the last two years, hog producers posted profits during the third quarter of 1981. Modest profits should continue over the next two or three quarters if the decline in hog slaughter, indicated in the latest USDA hog report, materializes.

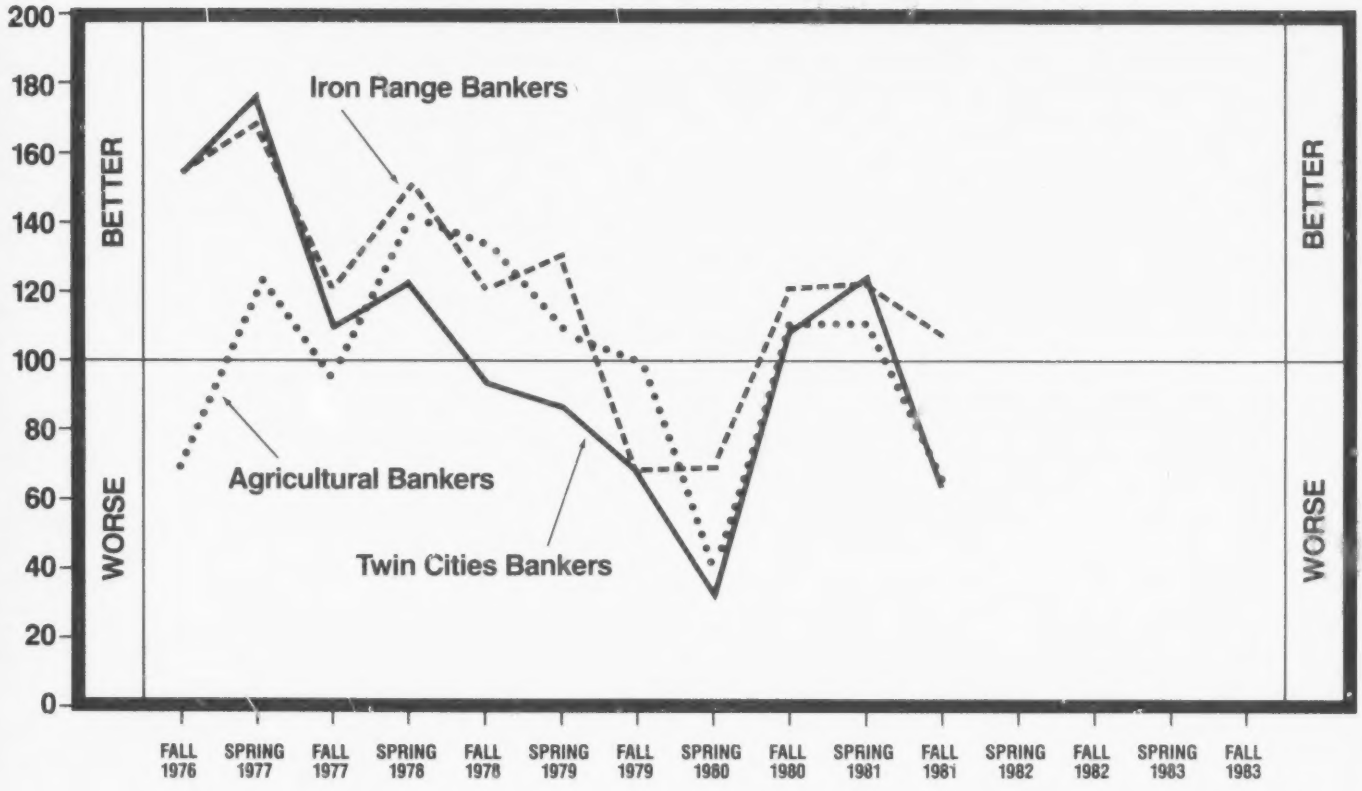
In response to lower feed costs and improved margins, hog producers are expected to increase production next year. Bankers in the region confirm this intention. The cyclic expansion in hog numbers is expected to begin around mid-year, with the first year-to-year increase in slaughter occurring during the third or fourth quarter. Restraint on expansion will be needed, however, if an early return to losses is to be avoided.

Cattle feeders continue to experience losses as weak demand and relatively large total meat supplies depress prices. In response to these losses, feedlot operators in the region have reduced the number of cattle on feed. Most bankers in the region do not anticipate increases in cattle feeding during the next six months. In addition, due to the long string of losses incurred by cattle feedlots, feeder cattle prices are expected to remain under pressure, despite the decline in feed costs.

Twin Cities: Bankers reported that economic conditions are declining in the Twin Cities at the present time. And they look for a sluggish 1982, unless interest rates come down substantially. Less than 10 percent of the bankers expected the Twin Cities economy to be stronger six months from now.

UPPER MIDWEST CONFIDENCE INDEX

Percent of bankers expecting economic conditions to improve
minus percent expecting conditions to deteriorate during the next six months plus 100.



High interest rates are expected to restrict consumer spending and business expansion. Only 13 percent of the Twin Cities bankers thought consumer spending will be stronger during the next six months, while over one-third foresee weaker consumer purchases. Three-fourths of the bankers said capital expenditures by business are lower than a year ago. Few bankers anticipate any improvement during the next six months.

Housing starts are also expected to be very limited due to extremely high mortgage rates. To cope with high rates, emphasis has switched to constructing high density type housing — townhouses and condominiums — as opposed to single family housing.

High interest rates are taking their toll on small businesses. Some small business failures were reported. Bankers said a number of undercapitalized operators are experiencing difficulties due to weak sales, particularly in the housing and transportation sectors.

Despite the flat performance anticipated during the next six months, the Twin Cities economy is expected to continue to outperform the rest of the state. This stronger performance can in part be traced to growth in the high technology sector and service industry employment. For example, in the Twin Cities metropolitan area, employment in health, business and other service industries has grown by over five percent during the past 12 months, nearly 60 percent faster than the state average. Job gains are expected to continue in these service industries during 1982.

Iron Range: Depressed economic conditions are anticipated for Minnesota's Iron Range due to heavy layoffs in the taconite industry and a weak wood products industry. Even before the recently announced layoffs, mining employment (although improved from a very poor 1980) was well below the peak reached during 1979. A number of bankers said they expected deteriorating overall economic conditions, with little improvement anticipated until mid-to-late 1982.

Credit Conditions

Agricultural Banks: Despite a modest rise in loan portfolios, farm loan demand remained sluggish at most agricultural banks in the region. Deposit growth was more than adequate to accommodate loan demand, despite evidence that deposit growth was beginning to slow. The survey also reveals that loan repayment rates slowed during the past six months; the average loan-to-deposit ratio edged upward for the first time since the fall of 1979; and interest rates on farm loans set a new high at the end of September, even as the national prime rate was starting to decline.

The rise in the average loan-to-deposit ratio during the past six months was a very modest one-half percentage point. At 60.3 percent, the average ratio at the end of September was still 2.4 percentage points below the year before and over 8.5 percentage points below the peak in the fall of 1979. Moreover, only 13 percent of the bankers considered their loan-to-deposit ratio too high, while 35 percent (an historically high number) of the bankers viewed their ratios as undesirably low.

CREDIT CONDITIONS

	Loan Demand (Index)*	Deposit Growth (Index)*	Loan Repayment Rates (Index)*	Typical Interest Rate (Percent)	Average Loan/Deposit Ratio (Percent)
AGRICULTURAL BANKS					
Fall 1976	N.A.	N.A.	63	8.9	57.5
Spring 1977	175	116	52	9.0	58.4
Fall 1977	182	121	69	9.0	62.5
Spring 1978	163	145	90	9.1	62.1
Fall 1978	179	157	105	9.4	64.9
Spring 1979	181	135	99	10.1	65.6
Fall 1979	187	124	67	11.4	68.9
Spring 1980	161	143	39	17.0	67.8
Fall 1980	102	175	98	14.2	62.7
Spring 1981	95	185	96	16.6	59.8
Fall 1981	138	178	71	18.8	60.3
TWIN CITIES BANKS					
Fall 1976	N.A.	N.A.	128	9.1	63.6
Spring 1977	175	175	114	9.4	61.4
Fall 1977	186	180	106	9.1	64.1
Spring 1978	188	166	105	9.7	64.4
Fall 1978	192	181	107	10.7	67.8
Spring 1979	186	169	102	12.0	68.9
Fall 1979	183	179	79	13.3	68.7
Spring 1980	162	157	90	18.2	71.1
Fall 1980	118	180	93	14.9	66.5
Spring 1981	104	166	94	18.9	65.6
Fall 1981	142	151	81	20.6	67.2
IRON RANGE BANKS					
Fall 1976	N.A.	N.A.	128	9.1	63.6
Spring 1977	150	144	119	9.4	60.4
Fall 1977	172	157	64	8.6	58.8
Spring 1978	187	150	107	10.0	70.7
Fall 1978	185	143	136	10.7	69.0
Spring 1979	162	139	123	11.9	70.9
Fall 1979	192	108	62	13.2	71.4
Spring 1980	123	162	92	18.7	69.9
Fall 1980	64	171	57	15.2	64.3
Spring 1981	0	143	79	18.0	61.1
Fall 1981	92	183	58	19.7	62.8

*Bankers responded to each item by indicating whether conditions at the present time are higher, lower or the same as a year ago. The index numbers are computed by subtracting the percent of bankers that responded "lower" from the percent that responded "higher" and adding 100. An index greater than 100 indicates conditions are stronger than a year ago, while an index less than 100 indicates conditions are weaker, slower, etc.

Some areas deviated considerably from the averages reported above. Bankers in eastern South Dakota reported a 2.8 percentage point decline in their loan-to-deposit ratio. On the other hand, loan demand and the upturn in the average loan-to-deposit ratio was the greatest in Nebraska and eastern Montana.

The average ratio at Nebraska banks increased three percentage points to 66 percent, but remainded below the previous peak of 69.6 percent. Similarly, in eastern Montana, the average loan-to-deposit ratio increased 3.6 percentage points to 62.4 percent, but remainded considerably below the previous peak. Consistent with these results, fewer bankers in these two areas considered their ratios to be lower than desired.

Looking ahead, however, bankers throughout the region expect loan demand will be quite weak. Crop operating loans is the only category for which significant increases are expected during the first half of 1982.

The typical rate charged for farm operating loans averaged a record high 18.8 percent at the end of September, up about two percentage points from last April and up over 4.5 percentage points from a year ago.

Within the region, interest rates on farm loans ranged from an average of 18 percent in Nebraska and Wisconsin to an average of 21.1 percent in western Montana. Most bankers did not expect interest rates to decline very rapidly. Some bankers reported a switch from the six-month money market certificate to the two and one-half year certificate because of more attractive rates. This was cited as a factor which would keep interest rates high.

The new highs in loan rates at agricultural banks reflect pressures on banks' operating margins from the increasing share of their deposits that are interest-sensitive and the restructuring of deposits that has occurred since the introduction of interest-bearing checking (NOW) accounts in January of this year. The record rates also reflect the general upward movement in market rates during much of the last six months.

Sixty percent of the banks surveyed said six-month money market certificates accounted for at least 30 percent of their consumer deposits. Due to the growth of these interest-sensitive deposits, 40 percent of the bankers said they were using a variable rate note.

Most banks indicated that loan repayment rates have slowed in their area due to weak farm income. North Dakota and the Red River Valley area in Minnesota are exceptions to this rule, with repayment rates improving as the recovery from last year's drought has begun.

While highly indebted operators and some beginning farmers and ranchers face a real bind, problem cases constitute a very small percentage of loans to farmers. Bankers report that the overall quality of credit remains high. As one Iowa banker explains: "Although we expect farm income to be reduced in 1982, the great majority of our farm operators are in relatively good financial shape. They will get along....(by) reducing their purchases of machinery, equipment, etc."

Farmers and rural communities are no longer isolated from the stresses of high interest rates. The introduction of the six-month money market certificate in mid-1978 more closely tied local farm loan markets to the national credit market. Prior to that time, farm loan rates were comparatively stable. However, the transformation of the bank liability structure that has occurred over the past three years has drastically altered that picture. Interest rates charged on bank loans necessarily have become more responsive to swings in rates in the national money market.

Since country bank costs of loanable funds are now integrated with rates in the national money market, rural areas are also more closely tied to the national business cycle than before. The reason for this is that, in addition to farm income, interest rates are now an important factor affecting the expenditure decisions of farmers and ranchers.

Twin Cities/Iron Range: While increasing during the past six months, loan demand remains sluggish at both Twin Cities and Iron Range banks. Moreover, bankers expect a decline in loan demand during the next six months, with the weakness being the most pronounced at Iron Range banks.

Although the average loan-to-deposit ratio increased 1.6 percentage points at Twin Cities banks during the past six months, it still is almost four percentage points below the peak reached in April 1980. In addition, 35 percent of the Twin Cities banks considered their present ratio as lower than desired. Similarly, while rebounding 1.7 percentage points during the past six months, the average loan-to-deposit ratio at Iron Range banks is still 8.6 percentage points below the peak set two years ago. Half of the Iron Range bankers viewed their current ratio as undesirably low and only eight percent considered their ratio too high.

Bankers in the Twin Cities and the Iron Range also indicated that loan repayment rates slowed during the past six months, reflecting the stress caused by high interest rates and a weakening economy. In late September, the typical interest rate charged on working capital loans averaged 20.6 percent at Twin Cities banks and 19.7 percent at Iron Range banks.

Looking ahead, bankers in both localities expect weaker loan demand during the next six months. Mortgage and consumer installment loans are expected to be the weakest, but commercial and industrial loan demand is also expected to taper off. At the same time, deposit growth is projected to be weaker than normal.

On the deposit side, six-month money market certificates continue to increase in importance. Almost two-thirds of the Iron Range banks said these certificates accounted for at least 30 percent of their consumer deposits. By comparison, these certificates accounted for 30 percent or more of consumer deposits at 35 percent of the Twin Cities banks.

Dr. Larry J. Wipf
Assistant Vice President and
Director of Regional Economics

Northwestern National Bank of Minneapolis
Seventh & Marquette
Minneapolis, Minnesota 55479
An Affiliate of Northwest Bancorporation
BANCO

Indicators is a publication of Northwestern National Bank of Minneapolis Economics Department. For further information contact Dr. Sung Won Son, Senior Vice President and Chief Economist, (612) 372-7871; Dr. Richard S. Smith, Vice President, Director of International Economics, (612) 372-5845; Dr. Larry J. Wipf, Assistant Vice President, Director of Regional Economics, (612) 372-9281; or Lola Johnson, Communications Officer, Corporate Communications, (612) 372-8027.

northwest economic
indicators
NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

1982 Economic Outlook

January 28, 1982

Highlights

- The regional economy has lost some of its buffer to national economic downturns. Financial deregulation has more fully integrated rural credit markets with the national money market. Our rural areas are no longer immune to the stresses of high interest rates and changes in national economic policy.

- A weak farm sector, depressed conditions in taconite mining and state budget problems will prevent the regional economy from snapping back as quickly as some other parts of the nation. Strength from high technology and service industries, however, will enable the Twin Cities economy to outperform the rest of Minnesota.

- Large crops, a tense international situation and a weak economy, both here and abroad, will dominate the agricultural scene well into 1982. After adjusting for inflation, real net farm income will show little improvement this year.

- National recovery from the current recession will begin when consumers resume stronger spending habits, while the strength of the recovery will depend on interest rate trends.

- A very large federal deficit in 1982, coupled with a continuation of the Federal Reserve's anti-inflationary monetary policy, will prevent sharp declines in interest rates from present levels. This will dampen the strength of the economic recovery.

Dr. Sung Won Son
Senior Vice President and
Chief Economist

- Consumer spending will not strengthen significantly before mid-year. The soft job market and a rising savings rate will weaken the effect of the July tax cut.

- Business spending also will remain weak until mid-year as inventory adjustments proceed. Plant and equipment spending will remain depressed throughout the year due to idle capacity and high capital costs.

- An improving inflation picture will be the main economic bright spot in 1982. Cyclical pressures on profit margins combined with moderating wage demands will help to control price movements this year and beyond.

Now it is official. The national economy went into a recession last July, and Minnesota's economy is in a recession along with it. However, unlike previous slumps, this one has the regional economy weaker than the national average. Business conditions have been especially soft in rural communities; however, even the Twin Cities lags behind the rest of the nation.

Regional Conditions

In November of 1981, nonfarm employment in Minnesota was 2.1 percent below the peak reached before the 1980 recession. At the same time, nonfarm employment in the Twin Cities was still 0.3 percent above the peak hit prior to the 1980 recession. Yet, even this performance fell short of the national average. In November 1981, U.S. nonfarm employment was still 0.8 percent above the 1980 peak.

The weakness in the Minnesota economy is widespread. On a seasonally adjusted basis, mining and construction employment are at their lowest level in four years. Manufacturing employment is only slightly above the trough reached during the 1980 recession. Joining these traditionally cyclical industries, employment has been either flat or declining in transportation, wholesale trade and government during much of the past two years. The only notable areas of growth continue to occur in health and business services.

REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME

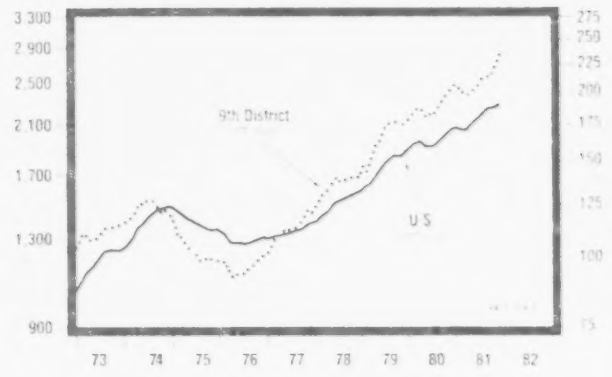
(seasonally adjusted annual rates)

billions of dollars

COMMERCIAL AND INDUSTRIAL LOANS

OUTSTANDING AT LARGE COMMERCIAL BANKS

(seasonally adjusted annual rates)

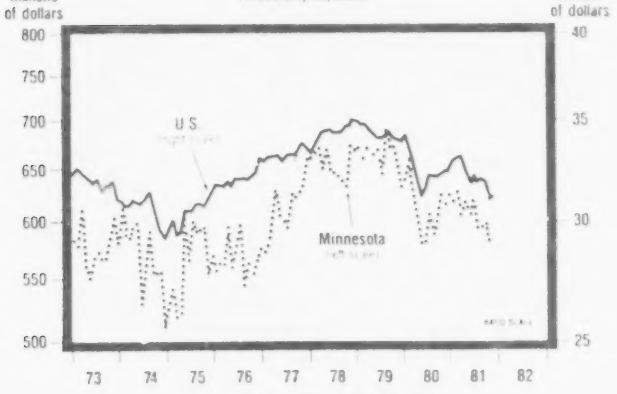


REAL RETAIL SALES

(seasonally adjusted)

millions of dollars

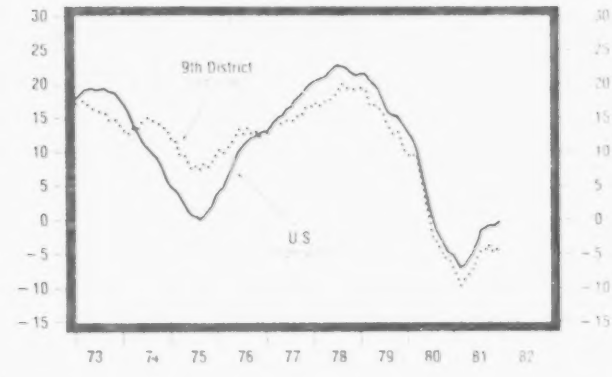
billions of dollars



CONSUMER INSTALLMENT CREDIT

OUTSTANDING AT COMMERCIAL BANKS

percent change from a year ago

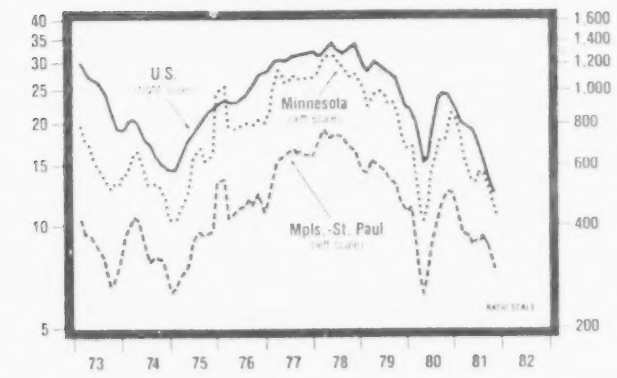


HOUSING UNITS AUTHORIZED

BUILDING PERMITS FOR 1-4 FAMILY UNITS

(seasonally adjusted annual rates)

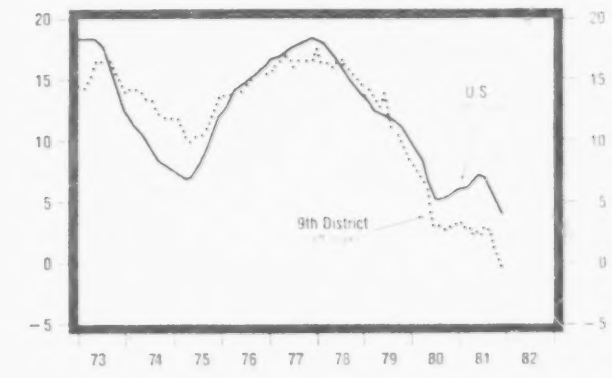
thousands of units, 3-month moving average



MORTGAGE LOANS

OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS

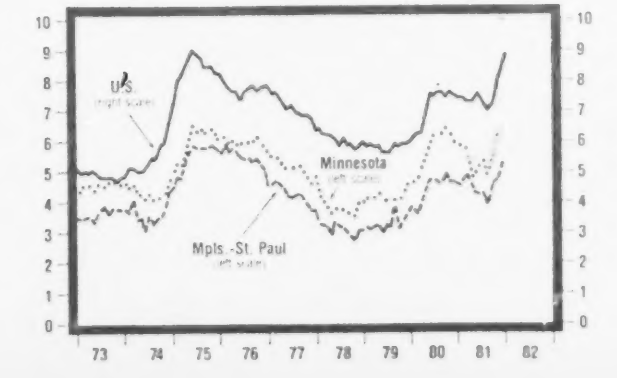
percent change from a year ago



UNEMPLOYMENT RATES

(seasonally adjusted)

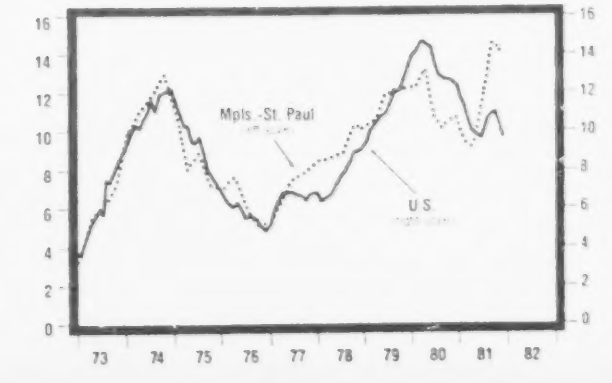
percent of labor force



CONSUMER PRICE INDEX

ALL ITEMS, ALL URBAN CONSUMERS

percent change from a year ago



Although the regional economy has typically fared better than average during national economic downturns, this is likely to be the exception from now on. Financial deregulation — such as the introduction of six-month money-market certificates in mid-1978 — has more fully integrated rural credit markets with the national money market. Farmers and businesses in our rural areas thus are no longer isolated from the stresses of high interest rates and changes in national economic policy. Accordingly, rural areas are now more closely tied to the national business cycle than before.

WAGE AND SALARY EMPLOYMENT
November 1981, Seasonally Adjusted

Industry	Minnesota	Twin Cities	United States
	(Percent Change From Peak Before 1980 Recession)		
Construction	-26.4	-27.0	- 7.0
Manufacturing	- 5.9	- 2.8	- 5.4
Mining	-26.3	N.A.	15.1
Wholesale/Retail Trade	- 3.1	- 0.8	2.1
Transportation/Utilities	- 5.6	- 3.4	- 0.8
*Finance/Insurance/Etc.	1.7	2.5	2.3
*Services	4.2	4.7	3.7
Government	- 2.2	- 2.3	- 3.2
Total Nonfarm	- 2.1	+ 0.3	+ 0.8

*Growth during past 12 months.

Regional Outlook

Looking ahead, while improving conditions are expected in 1982, the economic recovery in our region is likely to lag behind the national average. The farm, taconite and wood-products sectors are expected to remain fairly soft during much of the year. State budget problems will also dampen the regional economic recovery. Increased layoffs are likely due to cuts in state government expenditures and/or higher state and local taxes.

Spurred on by federal income tax cuts and lower inflation, the regional economy will improve during the second half of 1982. Rising interest rates during the recovery period, however, will sap some of the vitality normally present during the recovery phase of business cycles. A sluggish farm sector will also prevent our rural communities from snapping back as quickly as some other parts of the nation. The Twin Cities economy, however, will continue to outperform the rest of the state due to strength stemming from service industries and high technology businesses.

Large U.S. crops, a tense international situation and a weak economy, both here and abroad, will continue to dominate the agricultural scene well into 1982. This year, net realized farm income is expected to rise by only about 7 to 8 percent from depressed 1981 levels. Thus, after adjusting for inflation, real net farm income will show little improvement. Capital outlays and expenditures on farm machinery, especially big-ticket items, will remain weak during much of the year.

Despite this gloomy outlook, some improvement in both livestock and crop prices appears likely. A more complete recovery in farm earnings, however, is not expected until 1983. Even so, financial conditions vary considerably among individual farmers. The great majority of the farm operators in our region are in relatively good financial shape. They continue to cope by delaying major purchases and capital outlays. Highly indebted operators and some beginning farmers, on the other hand, are facing a more serious bind.

National Outlook

High and volatile interest rates precipitated the current national declin. Initially, interest-sensitive industr. s such as housing and autos were hurt, but economic weaknesses have spread throughout the economy.

When will the economic trough occur? This will depend upon consumers. How robust will the expansion be once the bottom of the current economic setback is reached? This will depend upon interest rates. Interest rates, in turn, will be heavily influenced by deficits and the Federal Reserve.

Deficits and Monetary Policy: The federal deficit for the current fiscal year is expected to approach $100 billion, or nearly two and a half times the original government estimate. Perhaps even more significant, the Reagan administration has now abandoned the original goal of a balanced budget by fiscal 1984. These developments are upsetting to financial markets and have become a significant source of uncertainty.

In the face of the worsening deficit outlook, the Federal Reserve will continue to pursue anti-inflationary monetary policy, keeping the growth of money supply within a range that will not promote, or be perceived as promoting, a resurgence of inflation. This means that interest rates, after adjusting for inflation, are likely to remain positive. Barring a sharp and prolonged economic decline, a major decline in interest rates from present levels is not expected.

In summary, the combined effects of fiscal and monetary policy over the next year will prevent interest rates from declining as sharply as rate movements in past cyclical downturns would lead one to expect. The relatively high level of interest rates will prevent a robust recovery once an economic trough is reached.

Consumer Spending: No meaningful recovery in consumer spending is expected before mid-year. The deteriorating job market will exert downward pressure on buying power, and reinforce conservative spending habits. In addition, the savings rate is likely to increase, a very typical phenomenon during recession. If the savings rate rises sharply, as it did during the 1974-75 period, consumer spending would be that much weaker. The new IRAs will contribute to consumer savings.

ECONOMIC OUTLOOK

January 1982

	Level (billions of 1972 $)			Percent Change from the Previous Quarter (Annual Rates)								Annual Percent Change		
				1981				1982E						
	1980	1981	1982E	I	II	III	IV	I	II	III	IV	1980	1981	1982E
Gross National Product	1480.7	1509.6	1501.4	8.6	—1.6	1.4	—5.2	—1.5	0.0	4.3	4.2	—0.2	1.9	—0.5
Consumer Expenditures	935.1	959.1	970.0	5.8	—2.1	3.3	—1.8	1.1	1.0	4.2	4.2	0.5	2.6	1.1
Durable Goods	135.8	139.4	137.5	24.0	—23.3	8.7	—19.2	1.0	1.0	15.0	12.0	—7.4	2.6	—1.4
Gross Private Investment	203.7	215.0	199.1	24.1	16.2	3.3	—23.6	—17.1	3.3	12.2	12.6	—12.5	5.6	—7.4
Business Fixed Investment	158.4	161.6	160.7	13.4	—2.2	7.1	—11.0	—2.6	—2.3	3.4	5.6	—3.0	2.0	—0.6
Net Exports, Goods & Services	52.0	44.3	41.8	50.9*	46.2*	43.2*	36.7*	43.0*	41.5*	42.0*	40.5*	37.6	—14.8	—5.6
Government Purchases	290.0	291.2	290.6	5.3	—5.5	—1.6	7.3	1.2	0.2	—0.3	1.4	2.9	0.4	0.1
	(Units specified)													
Consumer Price Index (1967 = 100)	247.0	272.5	294.0	10.8	7.5	11.9	8.5	6.6	7.4	7.1	7.5	13.5	10.3	7.9
Hourly Compensation (1977 = 100)	130.8	144.0	156.5	11.3	10.0	9.0	9.0	8.5	8.0	8.5	8.5	9.9	10.1	8.7
Labor Productivity (1977 = 100)	98.8	99.8	99.3	4.1	1.6	—2.0	—3.7	—1.0	1.0	2.0	2.0	—0.3	1.1	—0.6
Corporate Profits After Taxes (billions of dollars)	163.2	154.3	141.6	12.5	—33.7	9.8	—37.3	—15.0	10.0	25.0	20.0	—2.7	—5.4	—8.3
	(Units specified)			(Actual amounts at annual rates)				(Actual amounts at annual rates)						
New Passenger Car Sales (millions of units)	9.0	8.7	9.2	10.1	7.8	9.1	7.6	8.5	8.6	9.5	10.0			
New Private Housing Starts (millions of units)	1.3	1.1	1.2	1.4	1.2	1.0	0.9	0.9	1.2	1.3	1.4			
Unemployment Rate (percent)	7.1	7.6	9.0	7.3	7.4	7.2	8.4	9.1	9.3	9.0	8.5			
Federal Government Deficit (billions of dollars)	61.2	58.1	91.3	46.6	47.2	55.7	82.8	90.0	85.0	100.0	90.0			

E—Estimated

*Actual amounts at annual rates, not percent changes.

An improving inflationary picture during the first half of the year, along with the second round of personal tax cuts on July 1, 1982, will provide a sharp stimulus to personal income. This will trigger a recovery in consumer spending in the second half of 1982.

It should be noted that the rebound in consumer spending will be generated by increases in disposable income resulting primarily from the tax cut. Heavy use of consumer credit is not expected. Reliance on accumulated equity in housing will continue to be dampened by high mortgage rates. Strong inducements for personal saving, such as IRAs and positive real interest rates, will also distract from consumption spending.

Business Spending: Business spending is also expected to remain weak until at least mid-year. Less operating capital will be required during the first half of the year as inventories are brought down to a more desirable level relative to sales.

Moreover, spending on new plant and equipment is expected to remain weak throughout 1982. Weak business conditions, excess plant capacity, and still historically high capital costs will all act as depressants on this type of spending, with the exception of capital spending in the high-technology and defense-related industries. Capital spending normally lags behind changes in the overall rate of economic growth, and this particular business cycle will not be an exception to the rule despite the new, more favorable tax treatment of most capital expenditures.

Inflation: This will be the truly bright spot of the 1982 economic picture. Despite the Reagan administration's earlier pronouncements that supply-side economic programs would indeed lead to an improving inflationary trend, the financial markets and, to some extent, the general consuming public remained unconvinced. The present cyclical downturn, however, will provide evidence to all doubters that long-term, structural improvement in inflation is indeed possible.

The big improvement in 1982 will take place in the rate of growth of labor compensation. This is expected to slow down markedly as labor's chief bargaining concern in the soft economy switches from wage gains to job security. This will be a heavy bargaining year with major contract negotiations scheduled for, among others, the Teamsters, rubber workers, auto workers, and building trades. The ill health of these industries has not been lost on union leadership. The role of labor in maintaining and improving the competitiveness of these industries has never been more in the spotlight than now. This year, labor is likely to accept that it cannot expect to receive larger and larger slices of a shrinking pie indefinitely. Cooperation between labor and management in this major bargaining year could set the stage for long-term improvements in the competitiveness of many major U.S. industries. This alone would, in the longer term, be worth the present pain.

This report was prepared by:
Dr. Richard S. Smith
Dr. Larry J. Wipf

Northwestern National
Bank of Minneapolis
Seventh & Marquette
Minneapolis, Minnesota 55479
An Affiliate of Northwest Bancorporation

BANCO

Indicators is a publication of Northwestern National Bank of Minneapolis Economics Department. For further information contact Dr. Sung Won Son, Senior Vice President and Chief Economist, (612) 372-7871; Dr. Richard S. Smith, Vice President, Director of International Economics, (612) 372-5845; Dr. Larry J. Wipf, Assistant Vice President, Director of Regional Economics, (612) 372-9281; or Lola Johnson, Communications Officer, Corporate Communications, (612) 372-8027.

northwest economic
indicators
NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Long-Term National/Agricultural Outlook

April 6, 1982

Highlights

- **The continuing clash between monetary and fiscal policy is likely to prevent any early sustained recovery from the current recession. Under the present policy stance, there is a significant risk that rising interest rates will lead to another downturn next year.**

- **The economic climate would remain unfavorable under this stop-and-go scenario. Recoveries in the housing and durable-goods industries would be modest and temporary, at best, while capital-spending growth would remain weak. Financial stress would mount.**

- **Although policy adjustments aimed at reducing ballooning federal deficits are required before sustained recovery can be predicted with any certainty, important seeds have been planted that could bring an end to the seemingly annual recession pattern. Government is becoming smaller and more efficient and regulations less burdensome. The wage-price spiral is also winding down, setting the stage for lasting improvement on the inflation front.**

- **Over the past decade, increased reliance on exports, a shift to flexible exchange rates and financial deregulation have tied agriculture more closely to general economic developments here and abroad. This has added to the unpredictability and risk in agriculture. Good years will be better, and poor years will be worse.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

- **Sustained improvement in farm earnings is dependent on a shift in the supply-demand balance. Since current economic trends are not conducive to strong demand for agricultural products, the impetus for recovery may well depend on reduced supplies. The effectiveness of acreage-reduction programs will strongly influence future farm earnings.**

- **Despite rising world food needs, U.S. exports will be hampered in the near term by sluggish growth abroad and heavy debt loads in Eastern Europe and elsewhere. Crop shortfalls, due to bad weather in importing countries, will continue to play a major role in our grain exports. Bilateral trade agreements between the Soviet Union and other exporting nations have increased the role of the United States as a residual food supplier, causing greater volatility in crop prices.**

National Policy Dilemma

Just as a chronically ill person becomes weaker with each successive bout of illness, so also does an economy lose fundamental strength in a prolonged stagflationary environment. Unless policy adjustments are made to reduce ballooning federal deficits, there is a significant risk that a third recession in just four years will be entered sometime in 1983.

The current recession, characterized by economic declines and abnormally high real interest rates, is something President Reagan hoped to avoid when his supply-side programs were approved by Congress a year ago. The administration incorrectly assumed that financial markets would respond favorably to the package of spending and tax cuts, leading to reduced inflation, lower interest rates and sustained economic growth.

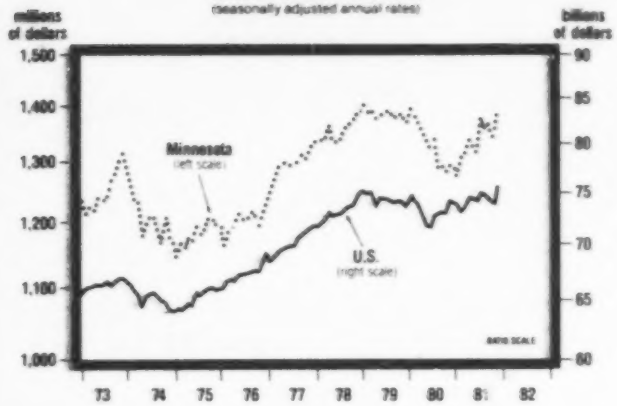
Instead, the financial community greeted the budget projections skeptically and took the stance that such a program held a high risk of generating additional inflationary pressures in the coming years. Rather than interest rates declining, they rose to near-record levels by mid-1981. Long-term capital remained expensive as potential investors opted for shorter maturities.

The resulting recession, induced by high and volatile interest rates, has darkened the deficit outlook even further. Serious doubts exist that the Administration's targets for economic growth through

REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME

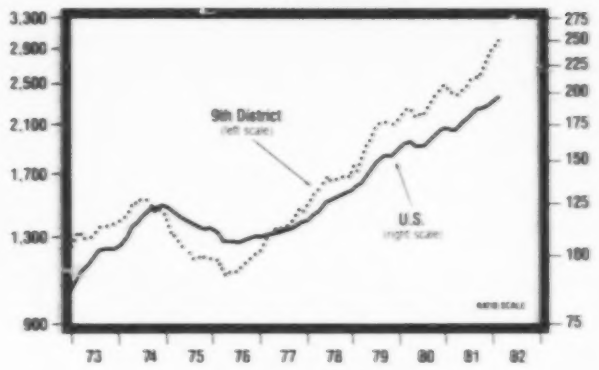
(seasonally adjusted annual rates)



COMMERCIAL AND INDUSTRIAL LOANS

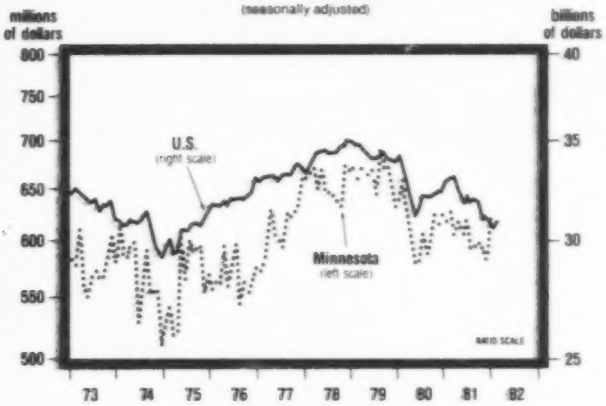
OUTSTANDING AT LARGE COMMERCIAL BANKS

(seasonally adjusted annual rates)



REAL RETAIL SALES

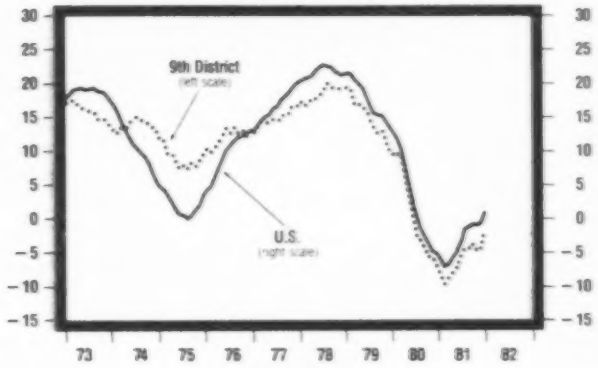
(seasonally adjusted)



CONSUMER INSTALLMENT CREDIT

OUTSTANDING AT COMMERCIAL BANKS

percent change from a year ago

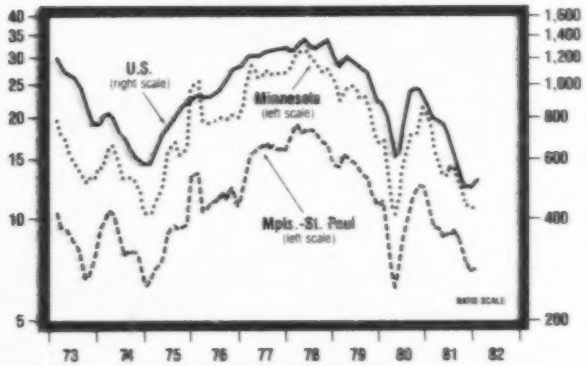


HOUSING UNITS AUTHORIZED

BUILDING PERMITS FOR 1-4 FAMILY UNITS

(seasonally adjusted annual rates)

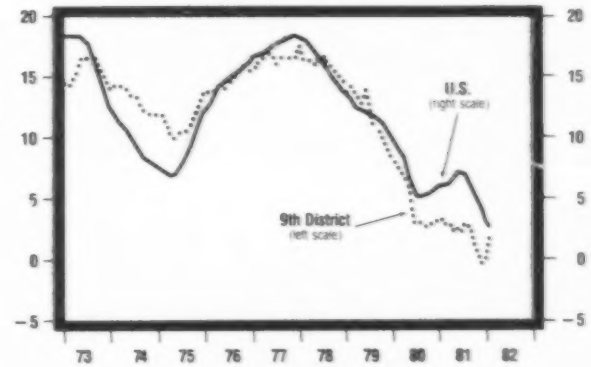
thousands of units, 3-month moving average



MORTGAGE LOANS

OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS

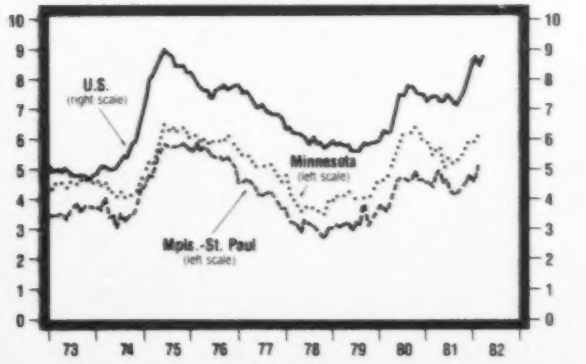
percent change from a year ago



UNEMPLOYMENT RATES

(seasonally adjusted)

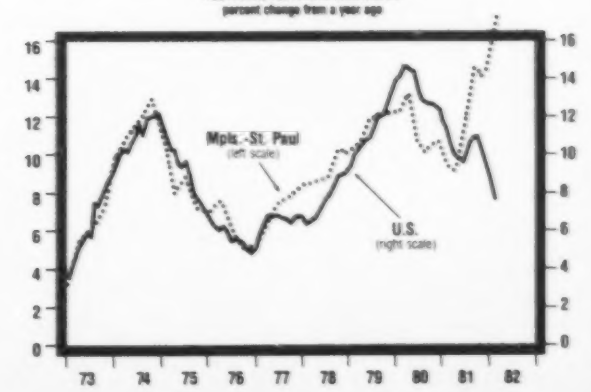
percent of labor force



CONSUMER PRICE INDEX

ALL ITEMS, ALL URBAN CONSUMERS

percent change from a year ago



1984 can be met. If they are not, tax revenues will fall short and expenditures will exceed present estimates, leading to a series of record budget deficits.

A sustained economic recovery, while possible, will require credible federal budget adjustments to reduce current deficit expectations. Such changes would benefit the financial-market outlook fundamentally and psychologically. Given anti-inflationary monetary policy, substantial deficit reductions would lower interest rates by reducing the government's share of total credit demands and removing at least a portion of the uncertainty premium prevalent in interest rates today.

Great uncertainty surrounds the prospects for reducing the budget deficit in the immediate future. Although Congress generally agrees that the projected deficits must be trimmed, there is no consensus over specific cuts. The President currently refuses to change the defense budget and personal tax cuts, but Congress is unwilling to make further substantial cuts in social programs.

There is a significant risk that the economy will remain in a stop-and-go-pattern until this impasse is resolved. Any recovery from the current recession will add rising private-sector credit demands to already-huge federal financing needs. As these demands clash with limited credit supplies, interest rates could be forced back to debilitating levels, triggering another economic downturn in 1983. Although this scenario may be avoided by eleventh-hour political agreements, it seems prudent to examine the business climate in this highly possible economic environment.

The Business Climate. Under this scenario, cash flow continues to be squeezed by weak sales and burdensome interest costs. Liquidity deteriorates further as businesses remain heavily dependent on the short-term markets for most credit needs. The risk of business failure increases as the recovery period is too short to allow businesses to recuperate financially. A sense of stability and direction is elusive.

Consumers' confidence remains weak in this environment, particularly as interest rates begin to rise again by early 1983. Income-tax cuts do not have as positive an effect on consumer spending as in previous recoveries. Housing continues to suffer as mortgage rates remain high, and a weak housing industry means continued soft demand for durable household goods. Uncertainty also hinders the automobile industry as consumers balk at taking on large debt burdens. Initially, much of the proceeds from the tax cut could be saved.

Weak consumer spending in a high-interest-rate environment bodes ill for capital investment. Continuing excess industrial capacity and high capital costs dampen the beneficial effects of a rising savings rate and accelerated depreciation allowances. Hence, capital spending remains weak.

Demographic influences will be largely positive over the next five years. The most significant demographic characteristic over this period will be a large increase in the more highly skilled and productive 35-to 39-year-old age group. Demand for housing and durable goods by this group should remain strong, particularly given pent-up demand. In addition, a continuing rise in the number of new households, due in large part to growth in single-adult households, will increase sales of durable goods. However, these beneficial demographic forces by themselves will not be strong enough to totally offset the adverse cyclical elements discussed above.

An Alternative Scenario. Although economic and financial strength is at present fragile, several important seeds have been planted that could avoid a continuation of the annual recession pattern.

Inflation is improving rapidly, and some of that improvement is more permanent than cyclical. Certainly, price increases have slowed due to the petroleum glut and cyclical weakness in the commodity markets. More important, however, is the beginning of a longer-term improvement in unit labor costs, or core inflation. Labor negotations in this heavy bargaining year are focused on job security issues, with wage concessions being granted. This bargaining pattern will translate into reduced inflationary pressures for years ahead.

Moreover, investors are aware of this improving trend. Current high real rates of interest are no longer due primarily to an inflation premium, but rather to uncertainty regarding the long-term strength of the real economy.

Also, a good chance exists that the budget difficulties of fiscal 1982 will be less severe in fiscal 1983. Any economic recovery, no matter how moderate, will lessen the deficit by increasing tax revenues and reducing transfer payments. In addition, 1983 is a post-election year, and congressional attention is likely to be more oriented toward pragmatic means of reducing the deficit.

Finally, recent economic difficulties have tended to overshadow the longer-term positive aspects of the President's economic program. Continued progress will be made toward a smaller, more efficient government sector. Consequently, its impact as a major generator of inflation will lessen.

The unfolding and growing recognition of these positive economic trends could very well have a powerful positive effect on business, consumer and financial-market psychology over the next few years. The stronger these trends are perceived to be, the better the chance that the current recession will be the last for several years.

Agriculture Challenged by New Environment

American agriculture is in a major recession. On a per farm basis, real net farm income is at its lowest level in 20 years. The resulting economic stress is evident on main street throughout the farm belt.

Although bumper U.S. crops are a major contributor to today's depressed farm sector, factors outside of agriculture also assume considerable importance. Agriculture is linked as never before to developments and economic prospects here and abroad. A weak world economy and foreign-policy decisions now have significant implications for agriculture. So do inflation and domestic economic policies that affect consumer demand, interest rates and the value of the dollar on foreign-exchange markets.

Three major developments in the 1970s are largely responsible for this increased dependence of American agriculture on general economic conditions and policies. These developments are: growing reliance on export markets, a shift to flexible exchange rates and, most recently, financial deregulation.

Reliance on Exports. In the early 1960s, the United States was a net importer of agricultural products. However, due to phenomenal growth of agricultural trade in the 1970s, American agriculture now relies on export markets for its vitality more than any other major industry group. Exports currently account for about 30 percent of the value of total farm sales. The output from one of every three acres of U.S. cropland goes abroad. For some individual commodities, the percentage of output entering export markets is even higher.

The internationalization of American agriculture was a major contributor to the economic health of the industry during the 1970s, encouraging greater production and boosting farm incomes. However, the risks associated with greater dependence on foreign markets also increased. Much of the variability in net farm income since the early 1970s can be related to our growing dependence on world markets.

Flexible Exchange Rates. A shift to flexible exchange rates in the early 1970s also greatly affected agriculture. Compared to fixed exchange rates, a flexible exchange rate places a greater burden on export-oriented sectors, such as agriculture, when monetary and fiscal policy is changed. During 1981, for example, record U.S. interest rates caused the dollar to soar on foreign-exchange markets. The stronger dollar actually made U.S. agricultural goods more expensive to foreign buyers during much of 1981, despite substantial declines in prices received by American farmers.

Financial Deregulation. During much of the 1970s, interest rates charged on loans by country banks remained relatively stable regardless of rate fluctuations in the national credit market. However, financial deregulation in the late 1970s more fully integrated rural credit markets with the national credit market. Since the advent of six-month money-market certificates in mid-1978, the rates that country banks pay depositors have risen sharply and are closely tied to the rates in the national money market. Consequently, the interest rates country banks now charge on loans necessarily have become more responsive to swings in national rates. Thus, interest rates have become a significant factor affecting both farm income and expenditure decisions of agricultural producers.

These three developments have significant long-term implications for agriculture. Farm income will continue to be more volatile than during the relatively stable 1950-1970 period. Moreover, although agriculture will have cycles of its own stemming from fluctuations in crop yields and other factors, trends in farm earnings will be tied more closely to general economic conditions and policies than in the past. Consequently, farmers and rural communities have an important stake in the resolution of our current general economic problems.

Agricultural Outlook

The problems that plagued agriculture during 1981 have not been resolved. Near-record crop inventories along with stagnant demand, both here and abroad, will continue to depress the farm sector in 1982. In the absence of significant crop losses because of bad weather, rapid and sustained improvement in farm earnings must wait for a shift in the supply-demand balance. An improving national and world economy will be very important. Unfortunately, a stop-and-go economic pattern is not conducive to strong demand for agricultural products. Thus, the impetus for recovery may well depend on reduced supplies. Accordingly, the effectiveness of this year's voluntary acreage-reduction programs for wheat and feed grains will be critical in influencing farm prices and income over the next couple of years.

A comparison of current crop prices and the program benefits suggest that participation in the farm program will be higher than normal, providing one of the necessary ingredients for at least a slow but sustainable recovery in the farm sector. Serious downside risk exists, however, if compliance with acreage-reduction programs is low and weather conditions are ideal. Although not predicted, another year of bumper crops to add to already burdensome inventories would cause serious problems for crop farmers well beyond this year.

Even if some improvement occurs on the supply side of the agricultural equation, recovery in farm earnings would continue to be retarded by weak general economic conditions, particularly if the U.S. economy remains stuck in a stop-go pattern. In addition, export growth is likely to remain weaker than normal over the near term.

Although world population growth will continue to increase world food needs, this does not necessarily mean expanded export markets. Sluggish economic growth in developed countries, debt problems in Eastern Europe as well as heavy debt loads in a number of developing countries will hamper growth of U.S. agricultural exports.

Fortunately, over the longer term, trade in agricultural commodities should continue to grow, albeit at a slower pace than in the 1970s. Crop shortfalls, due to bad weather in importing countries, will continue to play a major role in U.S. grain exports.

At the same time, bilateral trade agreements between the Soviet Union and other exporting nations such as Argentina and Brazil have increased the role of the United States as a residual food supplier. Although these nations cannot ensure all the imports the Soviets want in years of poor harvest, these agreements significantly reduce the size of the world open market, causing greater volatility in crop prices. In times of abundant world supply, the effect on U.S. prices will be disproportionately depressing. Conversely, with tight supplies, prices will rise to disproportionately high levels.

In conclusion, institutional changes during the past decade have tied the health of the agricultural sector more closely to outside forces. This has added to the unpredictability and risk in agriculture. Farm prices and earnings are likely to continue to fluctuate more sharply than in the past. As recent experience suggests, the bad years may be worse, but the good years will be better.

This report was prepared by:
Dr. Richard S. Smith
Dr. Larry J. Wipf

Northwestern National Bank of Minneapolis
Seventh & Marquette
Minneapolis, Minnesota 55479
An Affiliate of Northwest Bancorporation
BANCO

indicators is a publication of Northwestern National Bank of Minneapolis Economics Department. For further information contact Dr. Sung Won Son, Senior Vice President and Chief Economist, (612) 372-7871; Dr. Richard S. Smith, Vice President, Director of International Economics, (612) 372-5845; Dr. Larry J. Wipf, Assistant Vice President, Director of Regional Economics, (612) 372-9281; or Lola Johnson, Communications Officer, Corporate Communications, (612) 372-8027.

B6785-1

northwest economic
indicators
NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Spring 1982 Regional Economic Survey

May 12, 1982

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Highlights

- Although overall farm income is expected to decline this year, important differences exist within the farm sector. Most dairy operations remain profitable and should continue to provide stability for local communities. Reduced meat supplies have dramatically improved the profit picture for cattle and hog feeders. Weakness is now concentrated in the crop sector.

- The crop outlook is contingent on weather conditions and farmer participation in the acreage-reduction program. Compliance rates are expected to be relatively high. Besides providing price protection for program participants, high compliance rates reduce the risk of seriously depressed market prices for nonparticipants.

- The ability of farmers to survive difficult economic conditions depends on their debt load and management capabilities. While some heavily indebted operators are fighting to survive, those with strong management skills, diversified operations and/or smaller debt loads are fairly secure. Moreover, the number of farmers that are being forced to liquidate some of their capital assets is probably smaller than most people typically assume from the publicity agriculture has received.

- The Twin Cities economy has held up better than other portions of Minnesota. Although a quick recovery is not anticipated, Twin Cities bankers expect some improvement during the second half of 1982. Meanwhile, Iron Range bankers expect depressed conditions to continue for the remainder of the year.

- Credit conditions at most agricultural banks are characterized by fairly strong deposit growth, soft loan demand and slower repayment rates. Loan demand is projected to remain weak as farmers continue to curtail capital outlays.

- Loan demand is considerably stronger at Twin Cities' banks than in other parts of Minnesota. Loan-to-deposit ratios have risen during the past year, despite fairly strong deposit growth. Meanwhile, loan volume has declined at Iron Range banks.

This report presents the results of our twelfth semi-annual survey of bankers in the Upper Midwest and the Great Plains. Responses were received from more than 600 bankers located in the Twin Cities, Minnesota's Iron Range and agricultural communities in Iowa, Minnesota, Montana, Nebraska, North and South Dakota and western Wisconsin. The survey was conducted in early April.

Economic Conditions

Agricultural Communities: The problems facing agricultural producers have been widely publicized. Indeed, this year will be a difficult one. More than 80 percent of the bankers indicated that farm earnings are lower than a year ago. Nearly 60 percent said land prices are lower than a year ago, while only 2 percent reported increases. In addition, about 45 percent of the bankers expect overall economic conditions to deteriorate during the next six months, while 46 percent anticipate little change before the end of the year.

Nevertheless, the survey reveals that it is dangerous to generalize. While overall farm income is expected to decline again this year, important differences exist within the agricultural sector. The bankers indicated that most dairy operations continue to be profitable. Although concern was expressed over potential changes in the dairy program, many bankers think the sector will continue to provide stability for local communities, unless dairy price supports are cut sharply.

REGIONAL ECONOMIC CONDITIONS

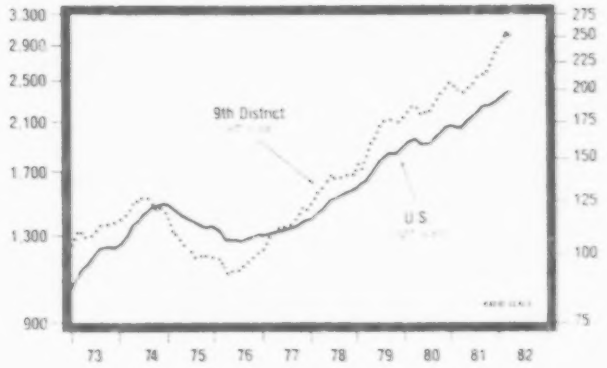
REAL PERSONAL INCOME

(seasonally adjusted annual rates)

COMMERCIAL AND INDUSTRIAL LOANS

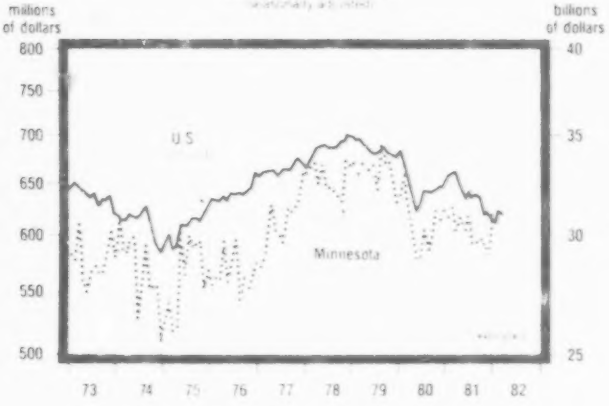
OUTSTANDING AT LARGE COMMERCIAL BANKS

(seasonally adjusted annual rates)



REAL RETAIL SALES

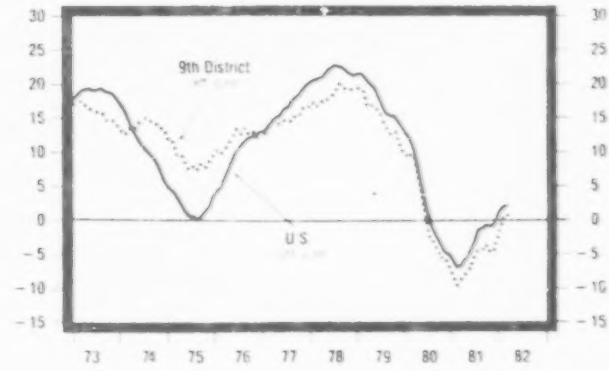
(seasonally adjusted)



CONSUMER INSTALLMENT CREDIT

OUTSTANDING AT COMMERCIAL BANKS

percent change from a year ago

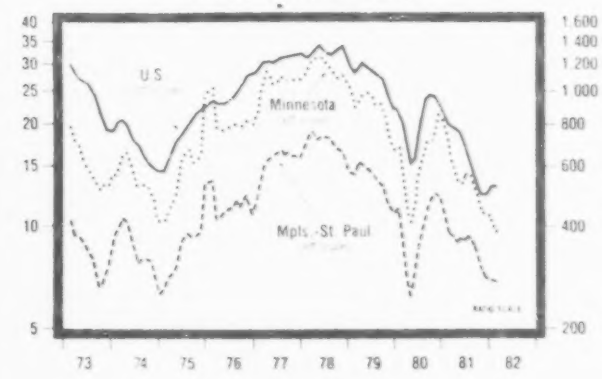


HOUSING UNITS AUTHORIZED

BUILDING PERMITS FOR 1-4 FAMILY UNITS

(seasonally adjusted annual rates)

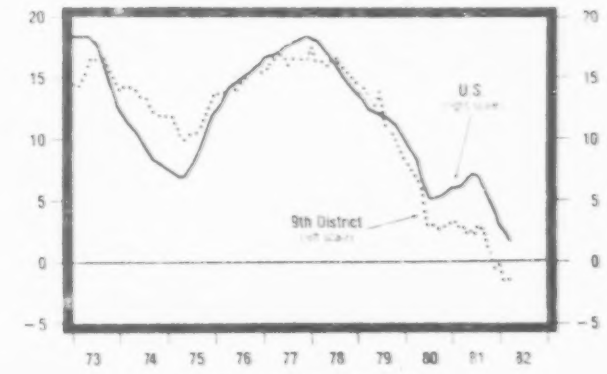
thousands of units, 3 month moving average



MORTGAGE LOANS

OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS

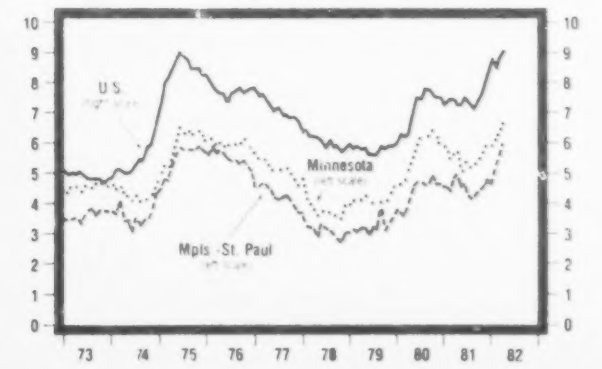
percent change from a year ago



UNEMPLOYMENT RATES

(seasonally adjusted)

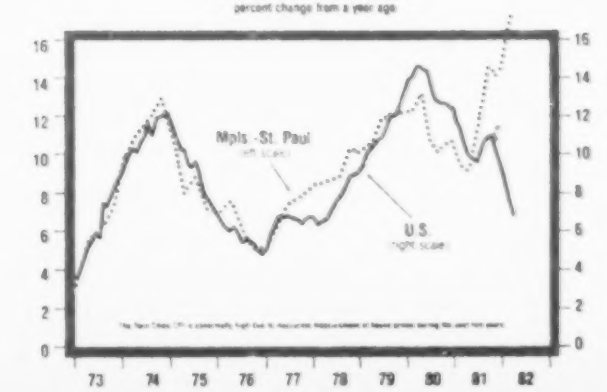
percent of labor force



CONSUMER PRICE INDEX

ALL ITEMS, ALL URBAN CONSUMERS

percent change from a year ago



Important shifts in profitability have also occurred for some agricultural sectors during the past year. Following a series of losses, cattle and hog feeders are now enjoying some profits. This markedly better income performance is expected to continue for the balance of the year. The crop sector is now the weakest in agriculture, as burdensome supplies and stagnant demand have pushed crop prices below the cost of production.

The outlook for crop prices is contingent on weather conditions and farmer participation in the acreage-reduction program. In order to be eligible for price-support loans and other program benefits, farmers are required to reduce wheat acreage by 15 percent and feed-grain acreage by 10 percent. Nationwide, 74 percent of the corn and sorghum acreage and 84 percent of the wheat acreage has been tentatively enrolled in the program. However, not all of these farmers are actually likely to participate in the acreage-reduction program. If few farmers comply, and if there is good weather, crop prices could decline substantially this fall.

The agricultural bankers estimate that about 50 percent of the wheat farmers will comply with the program. The estimates range from 30 percent for Minnesota and Nebraska to 60 percent for Montana and the Dakotas. Compliance with the feed-grain program is estimated at 40 percent for the region.

Besides providing price protection for the program participants, compliance rates of this magnitude nationwide would reduce the chances of another bumper crop and hence the risk of seriously depressed market prices for nonparticipants. However, with normal yields, little decline in carryover inventories can be expected. Even so, general market prices could be helped somewhat if enough participants place crops in the grain reserve, effectively removing that quantity from the market for up to three years. However, in the absence of significant crop losses due to adverse weather, rapid recovery in crop pices is not anticipated.

As can be seen from the previous discussion, while parts of the agricultural economy are becoming stronger, the overall agricultural outlook is not bright. The ability of farmers and ranchers to survive these difficult times depends heavily on current debt loads and management capabilities. While some heavily indebted operators are fighting to survive, farmers with strong management skills, diversified operations and/or smaller debt loads are more secure. As one Minnesota banker put it: "Our ag economy is composed of mostly conservative farmers, not highly leveraged, who should be able to withstand another poor economic year. At this time we foresee no financial difficulties that would result in foreclosure."

Not all farmers are this secure. Bankers indicated that low farm earnings and related financial problems will cause more than the usual number of farmers/ranchers to liquidate some capital assets during the next year. However, the number of farmers facing such prospects is still relatively small.

Bankers indicated that financial difficulties caused about 3 percent of their farm/ranch customers to liquidate at least part of their capital assets during the past 12 months. Although higher than normal, this percentage is probably less than people typically assume. Nevertheless, the problems are real and likely to grow if low farm earnings and high interest rates persist for another year or two. Bankers hazarded a guess that about 10 percent of their farm customers could be forced to liquidate some of their capital assets if conditions remained depressed for that period of time. While 1982 is expected to be a tough year for a number of agricultural producers, bankers look for improving conditions during 1983.

Twin Cities: Bankers indicate that the Twin Cities economy has not started to recover from the recession that began last fall. Wage and salary employment is now below the peak reached before the 1980 recession. Bankers estimated that adverse economic conditions have forced about 30 percent of their business customers to substantially reduce their level of operations. They also estimate that, during the past year, 2 percent of their customers discontinued operations due to financial difficulties. This percentage is considered somewhat higher than normal. Nevertheless, the Twin Cities economy has held up better than most other areas in Minnesota.

Looking ahead, 29 percent of the Twin Cities bankers expect overall economic conditions to improve during the next six months, while 21 percent expect economic conditions to deteriorate. Although guarded, this is a more optimistic appraisal than last fall. While bankers do not anticipate a quick recovery, the Twin Cities economy is likely to continue to outperform the rest of the state.

Iron Range: Bankers' appraisals of current economic conditions are more negative than last fall. High levels of unemployment in the mining industry have depressed both consumer and business spending. Iron Range bankers estimate that adverse economic conditions have caused half of their business customers to substantially reduce their level of operations during the past 12 months. Bankers also estimate that financial difficulties caused 5 percent of their customers to discontinue operations during the past year.

Unfortunately, the outlook for the remainder of the year is considered poor. Forty percent of the Iron Range bankers expect overall economic conditions to continue to deteriorate during the next six months, while only 7 percent expect some improvement. As a result, the confidence index for this area slumped to its lowest level since this survey began in 1976. However, contingent on a recovery in the national economy, the Iron Range banks look for improving conditions in 1983.

Credit Conditions

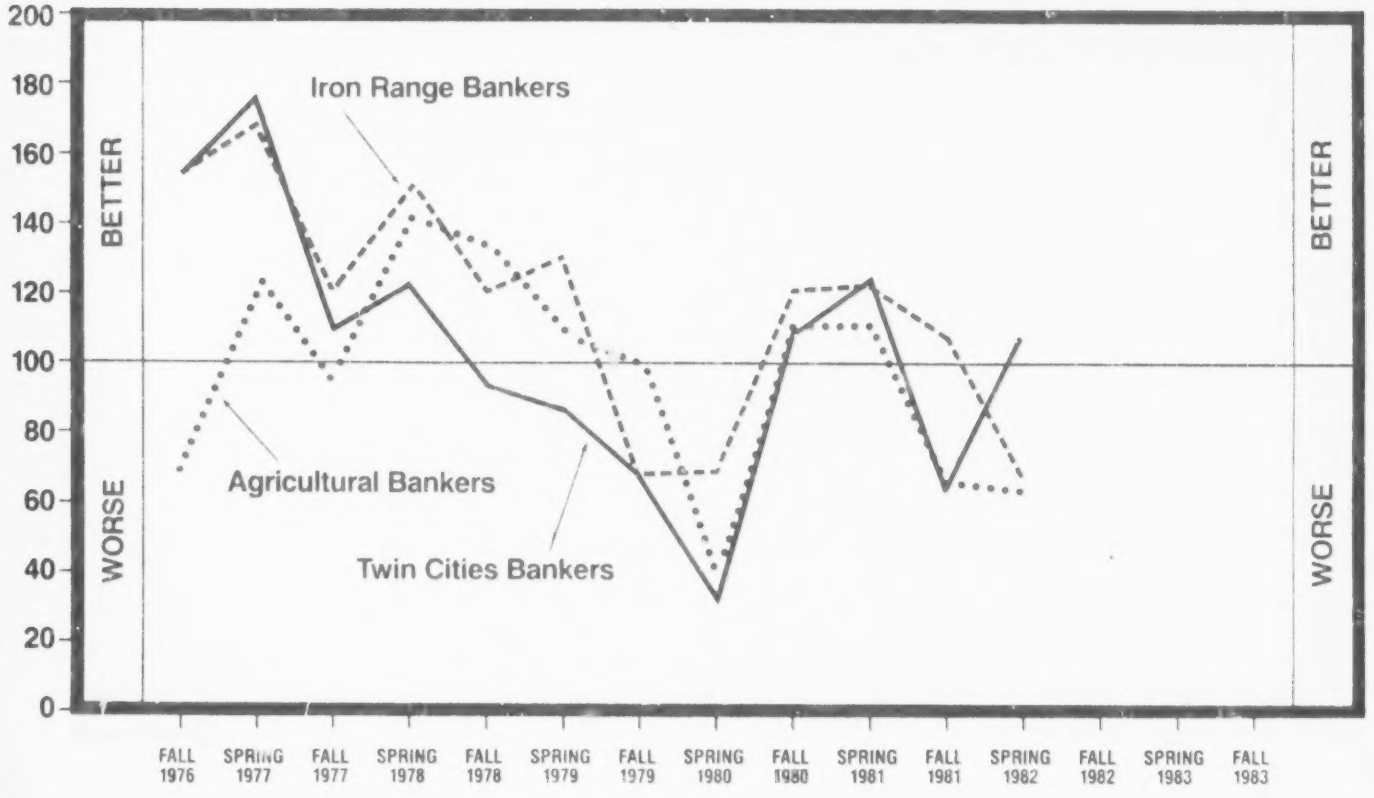
Agricultural Banks: Credit conditions at most agricultural banks in the region are characterized by fairly strong deposit growth, very soft loan demand and slower than normal loan repayments. Loan-to-deposit ratios fell to the lowest level in five years.

Although trending lower since last October, interest rates charged by agricultural banks remained high by historical standards. The typical interest rate for farm operating loans averaged 17.1 percent, down from 18.8 percent last fall but up one-half of 1 percent from a year ago.

Following a modest increase reported last October, loan demand slumped again at most agricultural banks in the region. About 35 percent of the bankers indicated that loans were above year-earlier levels, while 25 percent reported a decline in loan volume. Weak loan demand reflects the depressed level of

UPPER MIDWEST CONFIDENCE INDEX

Percent of bankers expecting economic conditions to improve
minus percent expecting conditions to deteriorate during the next six months plus 100



capital expenditures by farmers, lower livestock numbers and, to some extent, cash inflows generated by heavy use of Commodity Credit Corporation price-support loans for wheat and feed grains.

During the past three months, 75 percent of the banks sold participations (loans) to other banks, down from about 85 percent two years ago. Twenty percent of the banks sold participations to PCAs, only slightly lower than earlier survey periods. Among individual states, the number of banks selling participations to PCAs ranged from 5 percent in Iowa and Nebraska to almost 30 percent in North Dakota.

Deposit growth was fairly strong during the past year, a trend that has been evident since October 1980. This strong growth combined with weak loan demand caused the average loan-to-deposit ratio at agricultural banks to fall to the lowest level in five years. At 58 percent, the average ratio in early April was down nearly 2 percentage points from a year ago and 11 points below the abnormally high level set in October 1979. Only 14 percent of the bankers considered their ratio higher than desired, while 40 percent of the bankers (a historically high number) viewed their ratio as undesirably low.

Considerable variation exists among individual banks. Twenty-five percent of the banks had a loan-to-deposit ratio of 50 percent or lower, while 25 percent had a ratio of 68 percent or higher. Among individual states in the region, loan-to-deposit ratios tended to be above average in Wisconsin and Nebraska and considerably below average in North Dakota, Iowa and South Dakota.

Looking ahead, agricultural bankers expect loan demand to remain quite soft. Only 35 percent expect overall loan demand to increase during the next 12 months, while 19 percent expect loan volume to decline. Thus, anticipated loan demand is at its lowest level since the survey began in 1976. Loans for crop operating expenses are the only ones for which significant growth is anticipated. Although a slowing of deposit growth is projected during the months ahead, funds are expected to remain more than adequate to accommodate loan requests.

Financial deregulation has made the balance between interest-sensitive deposits and loans increasingly important. Most of the agricultural banks in the region appear fairly well positioned. Half of the banks reported that fixed-rate loans with maturities longer than one year accounted for only 20 percent of their total loans. These fixed rate loans accounted for 10 percent or less of the loan portfolio at 25 percent of the banks, while they accounted for 40 percent or more at another 25 percent of the banks.

On the deposit side, nearly 60 percent of the banks said six-month money-market certificates accounted for at least 30 percent of their consumer deposits. This is probably the biggest single source of interest-sensitive funds for country banks.

Weak economic conditions are affecting loan-repayment rates. Nearly 65 percent of the agricultural bankers said their customers were repaying loans at a slower rate than a year ago. Although similar to the response in early 1980, the current repayment rate is probably slower than in 1980 since that comparison was made

CREDIT CONDITIONS

	Loan Demand (Index)*	Deposit Growth (Index)*	Loan Repayment Rates (Index)*	Typical Interest Rate (Percent)	Average Loan/Deposit Ratio (Percent)
AGRICULTURAL BANKS					
Fall 1976	N.A.	N.A.	63	8.9	57.5
Spring 1977	175	116	52	9.0	58.4
Fall 1977	182	121	69	9.0	62.5
Spring 1978	163	145	90	9.1	62.1
Fall 1978	179	157	105	9.4	64.9
Spring 1979	181	135	99	10.1	65.6
Fall 1979	187	124	67	11.4	68.9
Spring 1980	161	143	39	17.0	67.8
Fall 1980	102	175	98	14.2	62.7
Spring 1981	95	185	96	16.6	59.8
Fall 1981	138	178	71	18.8	60.3
Spring 1982	110	159	40	17.1	58.0
TWIN CITIES BANKS					
Fall 1976	N.A.	N.A.	128	9.1	63.6
Spring 1977	175	175	114	9.4	61.4
Fall 1977	186	180	106	9.1	64.1
Spring 1978	188	166	105	9.7	64.4
Fall 1978	192	181	107	10.7	67.8
Spring 1979	186	169	102	12.0	68.9
Fall 1979	183	179	79	13.3	68.7
Spring 1980	162	157	90	18.2	71.1
Fall 1980	118	180	93	14.9	66.5
Spring 1981	104	166	94	18.9	65.6
Fall 1981	142	151	81	20.6	67.2
Spring 1982	139	157	70	17.7	67.8
IRON RANGE BANKS					
Fall 1976	N.A.	N.A.	128	9.1	63.6
Spring 1977	150	144	119	9.4	60.4
Fall 1977	172	157	64	8.6	58.8
Spring 1978	187	150	107	10.0	70.7
Fall 1978	185	143	136	10.7	69.0
Spring 1979	162	139	123	11.9	70.9
Fall 1979	192	108	62	13.2	71.4
Spring 1980	123	162	92	18.7	69.9
Fall 1980	64	171	57	15.2	64.3
Spring 1981	0	143	79	18.0	61.1
Fall 1981	92	183	58	19.7	62.8
Spring 1982	87	120	60	17.2	62.3

*Bankers responded to each item by indicating whether conditions at the present time are higher, lower or the same as a year ago. The index numbers are computed by subtracting the percent of bankers that responded "lower" from the percent that responded "higher" and adding 100. An index greater than 100 indicates conditions are stronger than a year ago, while an index less than 100 indicates conditions are weaker, slower, etc.

against a stronger base period. At the same time, about half of the agricultural bankers said they denied a larger than normal number of loan requests due to inadequate credit quality.

Iron Range: Loan demand is also weak at Iron Range banks. Only 27 percent of the bankers reported increases in loan volume during the past year, while 40 percent reported a decline in loan demand. The average loan-to-deposit ratio at Iron Range banks declined one-half of 1 percentage point to 62.3 percent. Although higher than a year ago, this ratio is more than nine points below the peak level reached in 1979, and nearly half of the Iron Range bankers felt their loan-to-deposit ratio was lower than desired. Moreover, most of these bankers expected loan demand to remain weak during the remainder of 1982.

On average, fixed-rate loans with maturities exceeding one year account for 60 percent of all loans at Iron Range banks. The comparable figure for Twin Cities banks is 50 percent. These percentages are substantially higher than those reported by agricultural banks in the region.

Twin Cities: Loan demand has been considerably stronger at Twin Cities banks than in other parts of Minnesota. Fifty-five percent of the Twin Cities banks said loans were higher than a year ago, while 16 percent experienced reduced loan volume. Although deposit growth was also considered to be fairly strong, the average loan-to-deposit ratio at Twin Cities banks increased to 67.8 percent, up six-tenths of 1 percentage point in the past six months and 2.2 points in the past year. About 30 percent of the bankers viewed their loan-to-deposit ratio as lower than desired, a more optimistic appraisal than from other bankers in the state. In fact, the average ratio is only 3.3 percentage points below the peak established in April 1980.

Just like other bankers in the state, Twin Cities bankers experienced slower loan repayments. About one-third of the bankers said their customers were repaying loans at a slower rate than a year ago, the poorest repayment record since this survey began in 1976. About the same number of bankers said they denied loan requests due to inadequate credit quality.

Looking ahead, bankers in the Twin Cities expect both deposits and loans to grow more slowly during the next six months. Demand for commercial and industrial loans, however, is expected to hold up better than demand for other types of loans.

Dr. Larry J. Wipf
Assistant Vice President and
Director of Regional Economics

Northwestern National
Bank of Minneapolis
Seventh & Marquette
Minneapolis, Minnesota 55479
An Affiliate of Northwest Bancorporation
BANCO.

Indicators is a publication of Northwestern National Bank of Minneapolis Economics Department. For further information contact Dr. Sung Won Son, Senior Vice President and Chief Economist, (612) 372-7871; Dr. Richard S. Smith, Vice President, Director of International Economics, (612) 372-5845; Dr. Larry J. Wipf, Assistant Vice President, Director of Regional Economics, (612) 372-9281; or Lola Johnson, Communications Officer, Corporate Communications, (612) 372-8027.

B6785-1

northwest economic
indicators
NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS — AN AFFILIATE OF NORTHWEST BANCORPORATION

How to Forecast Interest Rates

July 21, 1982

Highlights

- **Close to 10,000 businesses have failed thus far this year. Unless interest rates decline, business failures will increase rapidly.**

- **The unprecedented degree of uncertainty is primarily responsible for the large difference between interest and inflation rates. The fastest way to cut interest rates is to reduce uncertainties.**

- **The cloudy budget outlook and, according to monetarists, the volatile monetary growth are the main sources of uncertainties. A speedy resolution of the 1983 budget and stable monetary growth will help reduce uncertainties and, therefore, interest rates.**

- **In the meantime, the Treasury will raise close to $90 billion in cash during the second half of this year. The combination of the latest tax cut and the large Treasury borrowing will play havoc with the credit market.**

- **Later in the year, interest rates are likely to drop as the budget process is completed and private credit demand softens.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Current Conditions

Close to 10,000 businesses have failed thus far this year. The failure rate has more than tripled since 1978. Undoubtedly, there will be further fallout before the situation stabilizes.

The rapidly rising rate of business failures is one of the distinguishing features of the current economic downturn. There are others. An economic expansion used to last three to four years. This time around, the economy is in its second recession in as many years. Most important, interest rates, both nominal and real, have stayed at lofty levels despite the stop-and-go economic performance.

The stop-and-go economy and high interest rates have played havoc with American businesses. Production and the volume of retail sales have actually declined since the previous economic peak in 1979, resulting in rapid dropping corporate profits.

With the stop-and-go economy, businesses have not been able to employ labor and machines efficiently, and productivity has suffered. During economic recessions, business-credit demand at financial institutions is supposed to soften. Not this time! Poor profits have forced firms to borrow additional funds to meet working capital needs and payrolls. As borrowing increased, leverage (defined as the debt-to-equity ratio) has risen. Worse yet, the composition of the leverage has shifted in the wrong direction, away from long-term debt toward short-term. American businesses have been piling up short-term debts because long-term financing in the bond market has been unattractive. High interest rates and leverage have produced a cash-flow squeeze, and this has further impaired working-capital positions.

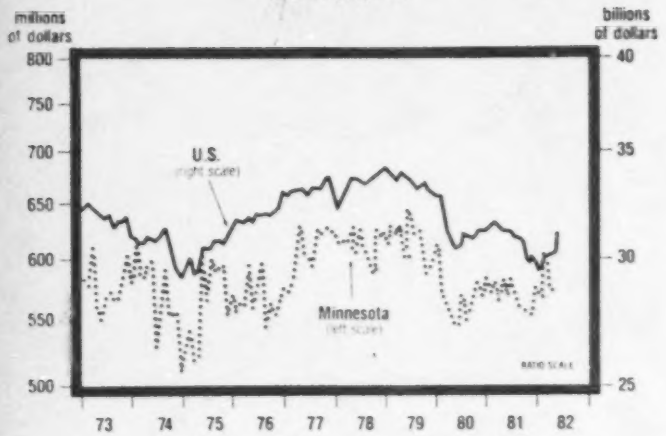
The conservation of cash has become the business sector's preoccupation. Inventories have been trimmed, capital spending postponed, dividend payments reduced and, in some cases, assets sold. For some companies these rash measures were not sufficient, and they became bankruptcy statistics of Dun and Bradstreet.

The above discussions suggest that the current economic recession is a "financial recession." There are financial imbalances that must be repaired before we can enjoy a sustained economic expansion. In other words, the direct cause of the recession is high and volatile interest rates.

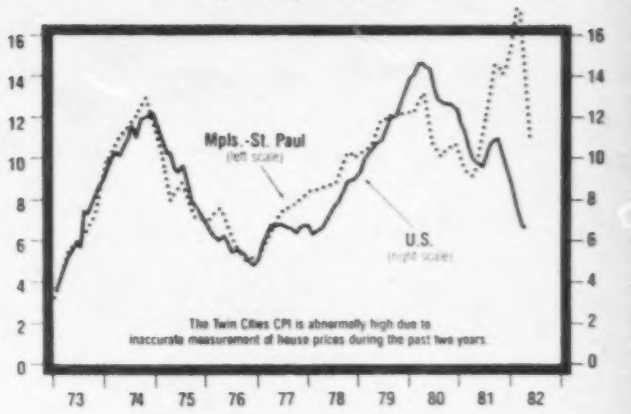
The general consensus among economists is that interest rates will decline slowly toward year-end. However, there are others who believe that the economy is in for substantially higher interest rates. Forecasting, especially interest-rate forecasting, is a

REGIONAL ECONOMIC CONDITIONS

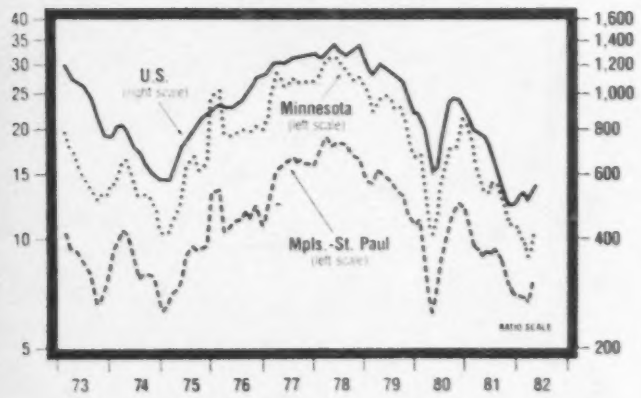
REAL RETAIL SALES
(seasonally adjusted)



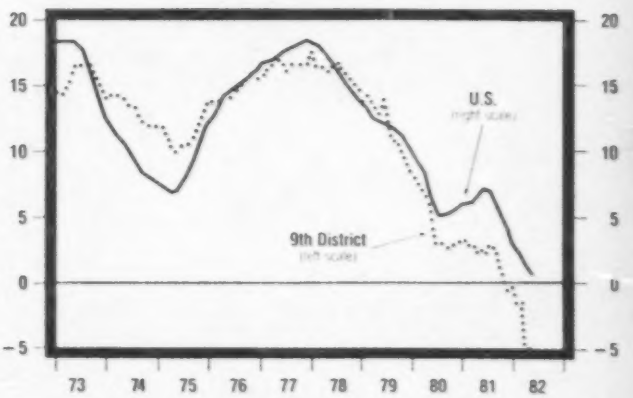
CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



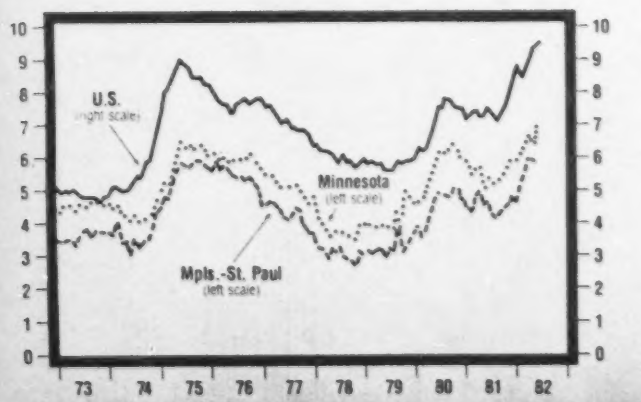
HOUSING UNITS AUTHORIZED
BUILDING PERMITS FOR 1-4 FAMILY UNITS
(seasonally adjusted annual rates)
thousands of units, 3-month moving average



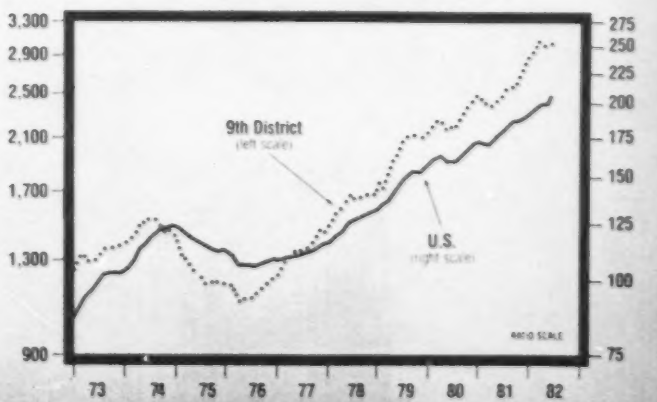
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS
(seasonally adjusted annual rates)



very hazardous game. All of us need to do our homework.

Interest-rate forecasts involve two steps. First, what will the general level of interest rates be? Will the level of interest rates change significantly from where they are now? Then, once the general direction has been mapped, the relationship between short and long-term rates needs to be determined. This is sometimes called the "term structure of interest rates." The yield curve could be sloping up or down depending on economic and financial conditions.

Forecasting the Level

There are numerous theories and tools in predicting the level of interest rates. One of these, known as "The Fisher Effect," says that the nominal interest rate consists of the real rate and expectation of inflation, or the inflation premium. The real rate reflects the productivity of physical capital, and the inflation premium depends upon the anticipated rate of inflation over the life of the asset.

Let us apply the simple formula. Both the prime and high-grade utility bond rates have recently been hovering around 16 or 17 percent. Participants in the financial markets seem to believe that the core rate of inflation in the foreseeable future is 6 to 7 percent. This implies that the real rate of interest is close to 10 percent. Historically, however, the real rate, as shown on Chart 1, has been much lower.

How do we explain the discrepancy? Certainly, the productivity of the economy has not improved that fast. Perhaps the high real rate is an aberration that will be corrected soon. If the inflation picture does not change dramatically, interest rates, both real and nominal, could come down as the real interest rate returns to the historical average.

Others have said that the unusually high real interest rate reflects uncertainties emanating from ballooning federal budget deficits and volatile monetary growth. In this case, somehow, the sources of investor uncertainty must be reduced to bring interest rates down.

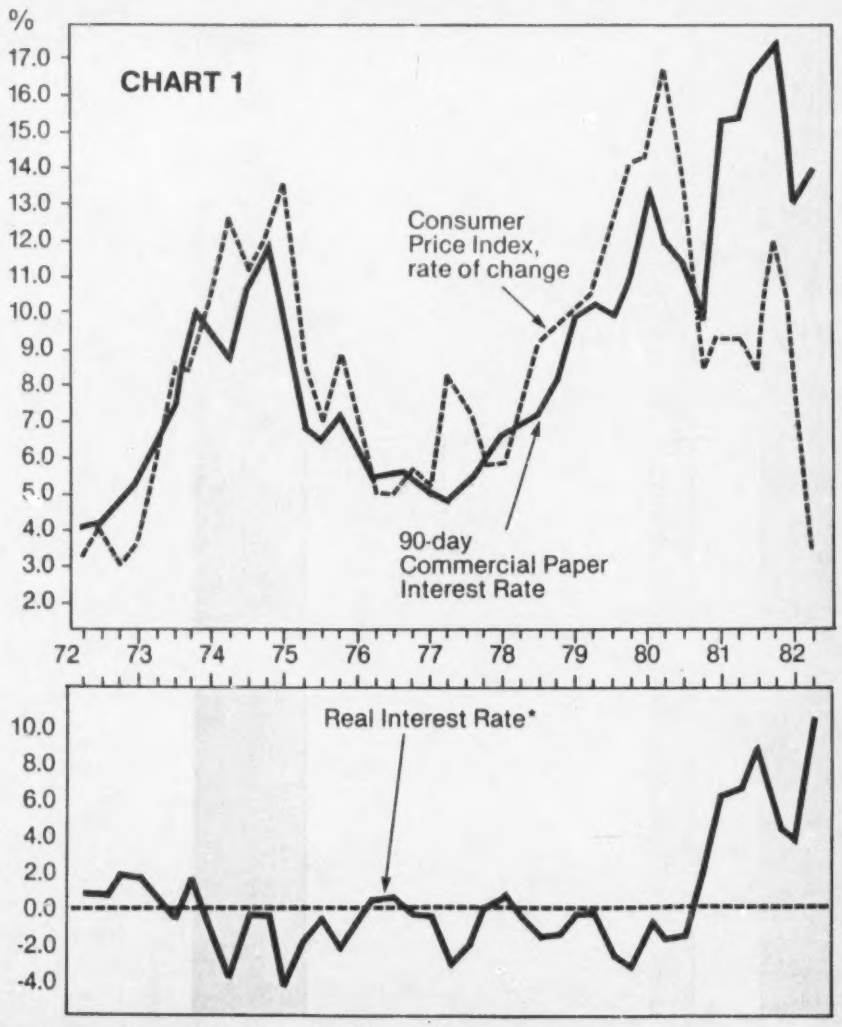
A variation of Fisher's inflation-premium doctrine is known as "The Harrod Effect." Unlike the Fisher Effect, which says that the nominal interest rate may be obtained simply by adding the prevailing level of inflation premium to the real interest rate, the formula used by Sir Roy Harrod reverses the emphasis between nominal and real interest rates. The nominal interest rate is determined by the supply of and demand for money. Then the inflation premium is subtracted from the nominal interest rate to calculate the real interest rate. With a given nominal interest rate, the higher the inflation premium, the lower the real interest rate. The key point of the Harrod Effect is that supply-and-demand forces determine nominal interest rates. The real rate then fluctuates in response to changes in the inflation premium.

Given sufficient time, changes in money supply and/or GNP will affect the supply-demand equation for money and the nominal rate. In the short run, however, a rise in the inflation rate will result in a Harrod Effect — a drop in the real rate of return on bonds and not a rise in the nominal rate.

In the current economic situation, the inflation rate, and therefore the inflation premium, has dropped rapidly. The Harrod Effect would imply in the short run that the real rate on bonds should have risen. Given enough time, however, changes in monetary policy and the level of economic activity will influence the inflation premium as well as real and nominal interest rates.

At the present time, businesses are concerned about the nominal interest rate. If we believe in Harrod's approach, the real interest rate is not all that relevant. Many economists use econometric models to predict nominal interest rates by combining supply and demand factors in the credit market. For example, the June issue of the *Data Resources Review* predicts that the prime rate will trough in the third quarter of this year before rising again.

INFLATION AND INTEREST RATES



*The Real Interest Rate is the difference between the 90-day Commercial Paper Rate and the Consumer Price Index.

Shaded area indicates recession

ECONOMIC OUTLOOK
July 1982

	Percent Change from Previous Quarter (Annual Rates)								Annual Percent Change		
	1982				1983						
	I	II	III	IV	I	II	III	IV	1981	1982	1983
Real Gross National Product	-3.7	0.0	4.5	4.5	3.0	3.0	3.5	3.5	2.0	-0.9	3.4
Real Capital Spending	-0.7	-20.0	-15.0	-8.0	5.0	7.5	8.0	8.0	2.5	-6.4	1.1
Consumer Price Index	3.2	4.3	7.0	6.0	7.0	7.5	6.0	6.0	10.3	6.2	6.5
Unit Labor Cost:	7.7	6.1	3.0	5.5	5.5	6.0	6.0	5.5	8.9	8.2	5.4
Hourly Compensation	8.1	6.6	7.0	8.0	7.5	7.5	7.5	7.5	10.0	7.6	7.5
Labor Productivity	0.4	0.5	4.0	2.5	2.0	1.5	1.5	2.0	1.1	-0.6	2.1
	Quarterly Levels: Seasonally Adjusted Annual Rates								Annual Levels		
New Car Sales (Millions of Units)	8.2	7.7	9.0	9.5	9.0	9.0	9.3	9.5	8.6	8.6	9.2
Housing Starts (Millions of Units)	0.9	0.9	1.2	1.3	1.3	1.2	1.3	1.4	1.1	1.1	1.3
Unemployment Rate (Percent)	8.8	9.5	9.6	9.5	9.3	9.0	8.6	8.4	7.6	9.4	8.8
Federal Deficit (Billions of Dollars)	123.5	127.0	155.0	150.0	120.0	110.0	130.0	120.0	62.4	138.9	120.0
Corporate Profits After Taxes (Billions of Dollars)	118.1	111.0	122.0	130.0	133.0	136.0	140.0	145.0	155.6	120.0	138.5

Who is right, Fisher or Harrod? The post-war data through the early '70s suggest that the truth lies somewhere between the contending theories. A similar conclusion holds true for a more recent period shown in Chart 1. During much of the '70s, the real rate remained reasonably stable despite volatile inflation rates. In the last year or so, however, the real interest rate shot up as the inflation picture improved a great deal.

So, both Fisher and Harrod are at least partially right. A fearless forecaster needs to heed both effects, and a forecaster must be able to predict which effect will dominate over the forecast period.

Yield Spreads

In the past decade, we have witnessed a period of unprecedented movement in interest rates in the financial markets. Two observations can be made from Chart 2 about the behavior of the interest-rate series. The first is that long-term and short-term rates generally move in the same direction. The second observation is that the spreads between the yields on different financial instruments do change substantially over time.

Let us discuss here the second observation, the variation of the spread among interest rates.

The characteristics that explain the variation include maturity, the issuer, tax implications, callability and the risk of default. We will limit our discussion to the term structure of interest rates that describes the relationship between interest rates and loan maturity. Generally there are three theories explaining the variability of the spread between short and long-term interest rates: expectations, liquidity and market segmentation.

According to the expectations theory, longer-term interest rates are simply a geometric average of shorter-term rates.[1] For example, a 90-day commercial paper rate is a function of three consecutive 30-day commercial paper rates. Today, a 90-day commercial paper rate is 13.42 and a 30-day rate is 13.79. This means that the market might expect the 30-day rate to decrease to 13.48 percent 30 days from now and 13.00 percent 60 days from now [1.1342287 = $\sqrt[3]{(1.1379)\,(1.1348)\,(1.1300)}$]. In other words, the geometric average of 13.79, 13.48 and 13.00 is roughly the 90-day rate, 13.42 percent.

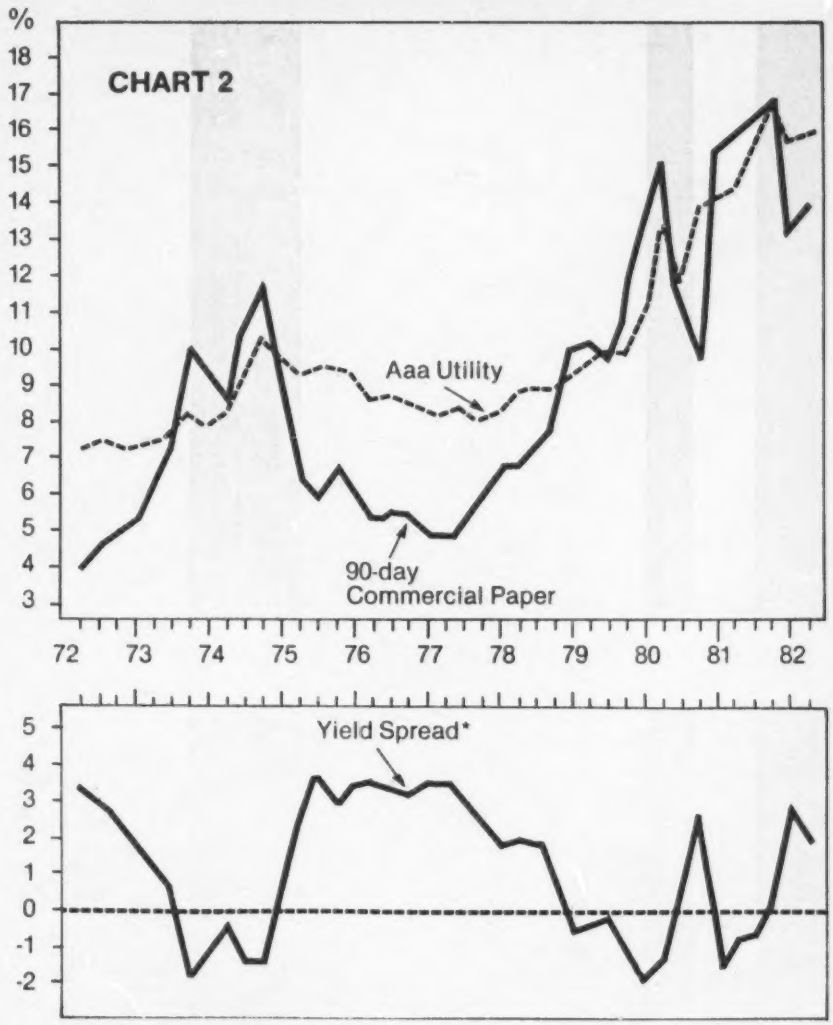
The expectations approach has some flaws. Suppose borrowers and lenders expect interest rates to be stable. According to the theory, both short and long-term rates would be the same. However, in a world of uncertainty, this is rarely the case.

Investors, in general, prefer to hold short-term instruments unless a liquidity premium persuades them to lengthen maturities. Borrowers generally prefer long-term instruments so that the debt would not have to be refinanced under adverse market conditions. This is the basic theory behind the liquidity preference theory.

The yield curve normally slopes upward because lenders have a bias toward short-term assets, while the borrowers have a bias toward long-term debt. Of course, the upward bias of the yield curve can be more than offset by interest-rate expectations, as has been true in recent times.

The third explanation for the term structure is the hedging-pressure, or

SHORT TERM AND LONG TERM RATES



*The Yield Spread is the difference between the Aaa Utility Rate and the 90-day Commercial Paper Rate.

Shaded area indicates recession

[1] This theory computes the long-term interest rate through the use of the following formula:

$$(1 + {}_{t}R_{N}) = \left[(1 + {}_{t}r_{1})\,(1 + {}_{t+1}r_{1}) \ldots (1 + {}_{t+N-1}r_{1})\right]^{1/N}$$

where t represents the period in which the given rate holds, R is the long term rate, r represents the short-term rates, and N is the number of short-term periods utilized in the calculation.

market-segmentation, theory. Insurance companies prefer to match maturities of assets and liabilities in order to have stable income. Borrowers tend to have similar desires to match assets and liabilities. According to this theory, short, intermediate and long-term markets are essentially separate. Funds do not flow back and forth freely. Bonds with different maturities are not substitutes for one another because of different maturity preferences and the preferred habitat of both lenders and borrowers.

As you may have guessed, empirical evidence provides some validity for each of the three theories. As a practical matter, a pragmatic forecaster must utilize all the information available.

Conclusion

Real interest rates are abnormally high. What has kept rates at such high levels? Uncertainties emanating from the dismal outlook for the federal budget deficit are the primary reason. In addition, monetarists have blamed volatile monetary growth for contributing to uncertainties.

If uncertainties are diminished, the real interest rate would be lowered. Chances are the inflation premium would also decline, leading to lower nominal interest rates. With lower real interest rate, the Fisher Effect would be reestablished.

If we focus on the Harrod Effect, a similar conclusion is reached. A more moderate federal budget deficit would reduce the demand for credit, bringing down the nominal interest rate. If the inflation premium remains stable, the real interest rate would come down. In short, both the Fisher and Harrod Effects imply that the size and handling of the federal budget deficit are key to bringing interest rates down.

What about the term structure of interest rates, the relationship between short and long-term interest rates? Let us apply the three theories: expectation, liquidity and hedging.

If the deficit picture improves, and monetary growth stabilizes, short-term interest rates would be expected to decline. Since long-term interest rates are a geometric average of short-term interest rates, long-term interest rates would be lower.

Turning to the liquidity theory, the liquidity premium associated with uncertainties would diminish if the deficit and monetary growth rates are under better control. Long-term markets would benefit more than short-term markets.

Finally, the hedging-pressure theory would argue that institutional investors such as life insurance companies, which have shortened maturities of assets, would be induced to return to their preferred habitat. The increased flow of funds into long-term markets would benefit the bond market.

From many respects, the federal budget deficit and the conduct of monetary policy are extremely important in bringing interest rates down. With reduced credit demand from the Treasury and reduced uncertainties, long-term markets would benefit more than short-term markets. Activity in the bond market would accelerate. Firms would use a significant portion of the proceeds from the bond market to reduce short-term debt. Short-term interest rates would be under further downward pressure. Both short and long-term interest rates would decline, and the yield curve would eventually slope upward again.

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Northwestern National Bank of Minneapolis
Seventh & Marquette
Minneapolis, Minnesota 55479
An Affiliate of Northwest Bancorporation
BANCO

Indicators is a publication of Northwestern National Bank of Minneapolis Economics Department. For further information contact Dr. Sung Won Sun, Senior Vice President and Chief Economist, (612) 372-7871; Dr. Richard Smith, Vice President, Director of International Economics, (612) 372-5845; Dr. Larry J. Wipf, Assistant Vice President, Director of Regional Economics, (612) 372-9281; or Janet Grant, Communications Officer, Corporate Communications, (612) 372-6704.

B6785-1 9/24/82

northwest economic
indicators
NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS — AN AFFILIATE OF NORTHWEST BANCORPORATION

International Risk

September 17, 1982

Highlights

- **Mexico's current financial difficulties illustrate once again the importance of country risk analysis. The concepts of this analysis are analagous to the concepts of standard company credit analysis.**

- **Every country has a socio-political environment which conditions the government's economic policies. This setting should be analyzed in a manner similar to a company's organizational structure.**

- **A country, like a company, has a leverage position. Those countries with large foreign debt burdens relative to their overall size are more susceptible to adverse changes in their external markets or product competitiveness.**

- **The relationship of a country's exports to its imports is similar in nature to the relationship of a company's sales revenues to its expenses. In each case, the former must exceed the latter over time if financial health is to be maintained.**

- **Largely as a result of its foreign-exchange policies, Mexico "priced" many of its exports out of international markets. These policies, however, led to a corresponding surge in its imports. As recent events have shown, this unsustainable trend ultimately led to an international financial crisis.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Credit Risks

Mexico, like many well-publicized U.S. companies, is currently experiencing a severe liquidity crisis. Many investors, creditors and suppliers to its economy are faced with the possibility of delayed payments or returns on their particular transactions.

Mexico is not unique, however. Other countries face actual or possible international financial crises resulting from a prolonged period of world economic stagnation. But, the example of Mexico illustrates once again the importance of careful analysis of any country's economic conditions and policies before making international financial transactions.

Fortunately, the concepts of country-risk analysis and the more-familiar company-risk analysis are quite similar. Countries may find themselves facing financial difficulties analagous to those encountered by distressed companies. Any company, over time, must generate revenues in excess of expenses to avoid consumption of its capital base.

Similarly, countries, over time, must generate foreign convertible currencies through exports of goods and services sufficient to cover the cost of needed imports and debt-servicing requirements. The world-wide economic turmoil of the past three years has resulted in liquidity problems for those countries that have been least able to maintain export-revenue levels and/or compress imports and that have had the heaviest burdens of floating-rate convertible debt.

The concept of credit risk is thus expanded in international business. A U.S. supplier of goods, credit or other services must be concerned not only with the creditworthiness of an individual foreign customer but also with the creditworthiness (or ability to generate sufficient foreign exchange) of the customer's country. Each analysis requires study of the organizational structure, the balance sheet and the income statement.

Country Analysis

Any company credit analysis begins with judgments concerning the ability of the company to weather changes in its external environment, and so it is with country analysis. Careful consideration must be given to a country's management, its "labor relations" or socio-political climate and the characteristics of its "product" or export lines.

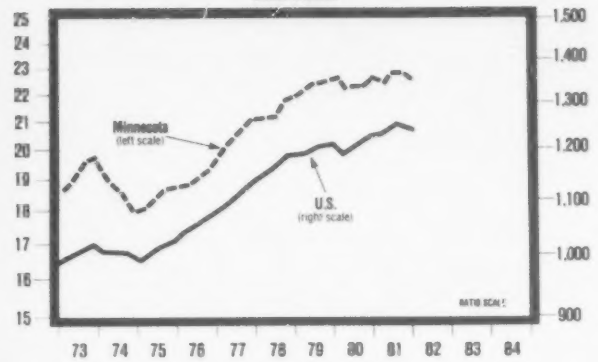
A government's ability to manage its financial and real resources, in good times and bad, is a key element in maintaining a good national credit rating. In

REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME

(seasonally adjusted annual rates)

billions of dollars

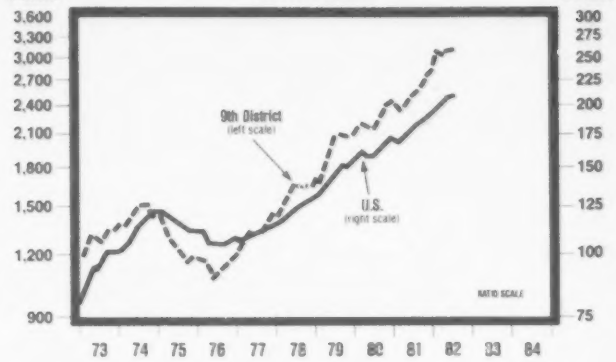


COMMERCIAL AND INDUSTRIAL LOANS

OUTSTANDING AT LARGE COMMERCIAL BANKS

(seasonally adjusted)

millions of dollars / billions of dollars

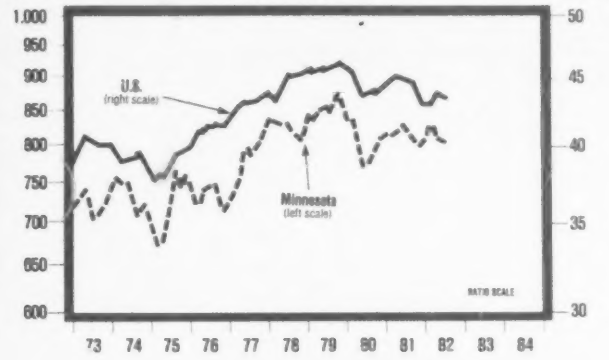


REAL RETAIL SALES

(seasonally adjusted)

3-month moving average

millions of dollars / billions of dollars

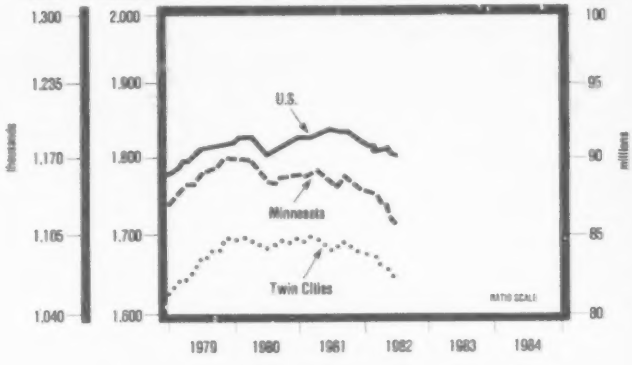


NONFARM EMPLOYMENT

(seasonally adjusted)

Twin Cities / Minnesota / United States

thousands / millions

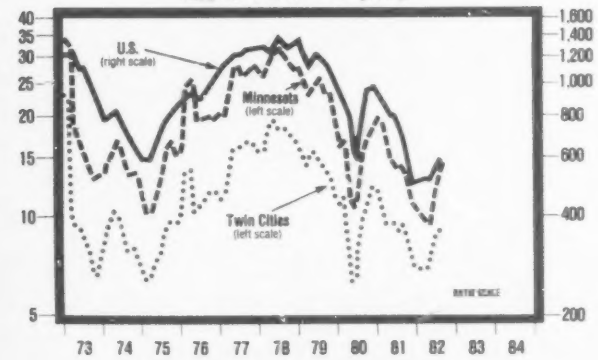


HOUSING UNITS AUTHORIZED

BUILDING PERMITS FOR 1–4 FAMILY UNITS

(seasonally adjusted annual rates)

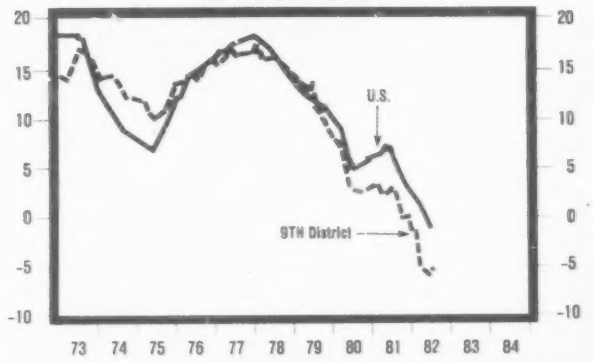
thousands of units, 3-month moving average



MORTGAGE LOANS

OUTSTANDING AT INSURED SAVINGS AND LOAN ASSOCIATIONS

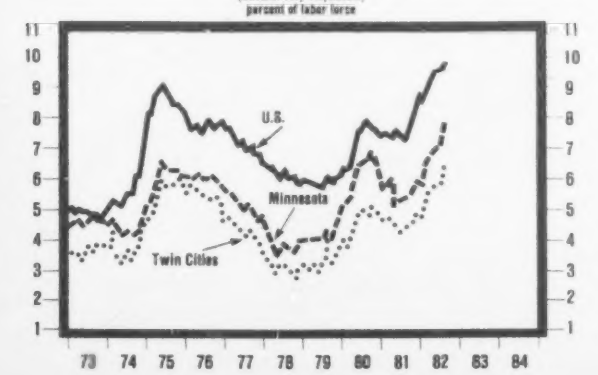
percent change from a year ago



UNEMPLOYMENT RATES

(seasonally adjusted)

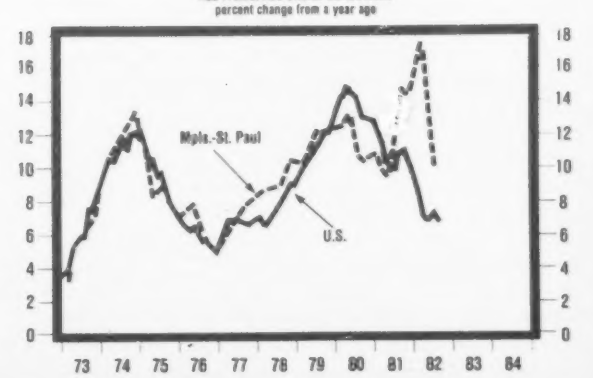
percent of labor force



CONSUMER PRICE INDEX

ALL ITEMS, ALL URBAN CONSUMERS

percent change from a year ago



good economic times, when foreign-exchange surpluses from ongoing trade operations are being generated, it is important to know how those surpluses are being used. Are they being used to reduce existing foreign debt or to import equipment to improve the country's capital base, or are they instead being used to finance the increased importation of luxury consumer goods? Conversely, in bad times, the government should possess the ability and willingness to take often unpopular measures (currency devaluation or import controls, for instance) that will conserve scarce foreign-exchange resources.

A company's ability to take cost-cutting measures often depends on the willingness of its labor force to accept these measures. Likewise, the ability of a country to adopt the sometimes draconian economic measures necessary to ensure international financial health depends largely on the willingness of the population to accept a temporary reduction in living standards. If the introduction of unpopular measures is deemed likely to result in crippling strike activity or a counterproductive change in government, international financial health is likely to suffer.

Diversification of a company's product line and market area can protect it from the catastrophic results of a severe drop in revenues generated by one or a few products or markets. The same holds true for a country's exports. The narrower the export and market base, the more susceptible is a country's foreign-exchange-generating ability to price, demand or other external events beyond its control. No single export or market area can be considered absolutely safe from shifts in world market and political forces.

The Balance Sheet

Analysis of a company's balance sheet - its stock of resources and financial obligations - is a basic part of credit analysis. Likewise, a counterpart analysis of a nation's stock of resources and foreign financial obligations will provide a knowledgeable judgment of its ability to service foreign debts regardless of deterioration in its ability to generate foreign exchange.

Absolute size, measured in terms of total assets, is a useful measure, when combined with leverage analysis, of both a company's and a country's ability to shoulder additions to debt. In general, the larger a company, the greater its ability to spread cost-cutting measures throughout the organization, thereby protecting creditors' rights without totally impairing its operations. Likewise, the richer a country in terms of raw material, capital and labor resources, the greater its probable ability to reallocate those resources in favor of external creditors.

An analysis of liquidity, the relationship of short-term assets to short-term liabilities, is vital in credit analysis of both companies and countries. An important liquidity test in company analysis is the acid test ratio, which determines the ability of a firm's cash and near-cash assets to cover its current liabilities. The analagous test in country-risk analysis measures the ability of a country's level of international reserves (convertible currencies and gold holdings valued at market prices) to cover its foreign-exchange requirements for foreign-debt service payments and/or necessary imports.

Leverage analysis tests the ability of a company or country to add further to its debt burden. The country-analysis counterpart to a company's total debt/equity ratio is the size of its total external debt relative to its gross national product (used here to represent the country's asset stock). The more leveraged a country is, particularly in relation to other countries at similar stages of development, the more onerous the burden of debt-service obligations. A highly leveraged country, like a highly leveraged company, may find it more difficult to obtain additional loans when most needed.

National Income

Foreign-currency earnings from the export of goods and services represent a country's sales revenues while foreign exchange expenditures on imported goods and services represent its expenses. Like a company, a country's financial health is dependent over time on its ability to control the relationship between revenues and expenses.

Revenues are directly related to the demand charactristics of the product(s) sold. Any country-risk evaluation must address the elasticities, or sensitivity, of export demand to changes in product price and customer-country income. Export revenues vary in many developing countries because demand for their raw materials exports tends to be price inelastic and income elastic. Consequently, their export revenues fluctuate widely as world economic conditions change, with export revenues very high in good economic periods and dismally low in poor ones.

The competitiveness of a country's exports on world markets must also be examined. Just as the consumer will usually buy a product that provides the most value per dollar spent, so also will importers make their purchasing decisions. Capital/labor ratios in each production process, in conjunction with relative factor costs (i.e., wage rates, skill levels and capital availability), determine the export products or services in which any country possesses a competitive advantage.

Poor pricing decisions are a common cause of lost revenue at the company level. Likewise, improper exchange-rate policies are a common cause of lost export revenues. A classic method of domestic inflation control is the practice of maintaining an overvalued currency. While such a policy holds down the local currency price of imported goods, it will eventually generate the type of international liquidity crisis that exporters seek to avoid. Overvaluation of a currency has an adverse effect on the price competitiveness of most exports in direct proportion to the beneficial price effect on imports. A continuing policy of currency overvaluation is a sure way to eventual balance-of-payments difficulties.

Mexico: An Example

Mexico currently represents a classic case of a national-level liquidity crunch. Despite its emerging role as a major oil exporter, Mexico has temporarily exhausted its "cash" or foreign-currency reserves. It is presently unable to service its foreign debt on a timely basis or to maintain previously established import levels.

Mexico, as one of the more rapidly developing countries, is similar to a growth-oriented young company. Rapid growth occurs when market conditions are favorable, but market deterioration can lead quickly to a financial squeeze. The continually rising expectations of the fast-growing Mexican population have made it difficult for the Mexican government to ward off the current crisis.

The country's oil-generated growth of export revenue has been more than offset by its failure to control import expenditures. Moreover, rising interest rates on its large foreign debt contributed to the deterioration in its current account bal-

Mexico

International Economic Indicators

(Millions of U.S. Dollars except as indicated)

	1978	1979	1980	1981
Exports	6,246	9,302	16,241	19,837
of which: petroleum (%)	31	44	63	68
Imports	-7,992	-12,132	-18,551	-23,166
Trade Balance	-1,746	-2,830	-2,310	-3,329
Service Inflows	5,370	6,939	8,709	10,402
Service Outflows	-6,797	-9,584	-13,975	-20,070
Current Balance	-3,173	-5,475	-7,576	-12,997
Euromarket Borrowings	7,818	8,606	6,515	10,542
Non-Gold Reserves (at 12/31)	1,842	2,072	2,960	4,074
Import Coverage (months)	2.8	2.0	1.9	1.3
Inflation - Mexico (%)	17.3	18.2	26.4	27.9
Inflation - U.S. (%)	7.5	11.3	13.5	10.4
Inflation Differential (%)	9.8	6.9	12.9	17.5
Peso Adjustment (%)	-0.9	-0.2	-0.6	-6.8
Real GNP Growth (%)	8.3	9.2	8.3	8.0

Source: International Monetary Fund
International Financial Statistics

ance from $3 billion in 1978 to $13 billion in 1981. Mexico continued over this period to offset these rising "losses on continuing operations" by additional foreign borrowings, many of which were short-term in nature. Consequently, both liquidity and leverage ratios suffered.

Over this four-year period, the country continued to increase its international reserves. However, the rate of increase was less than the rate of increase in foreign-exchange requirements. The result was a substantial decline in the relative level of liquidity protection afforded by its international reserves through 1981.

The Mexican monetary authorities made what has now proved to be a very serious pricing error. The failure to adjust the value of the peso commensurate with inflation differentials between Mexico and its major trading partners sharply hurt the price competitiveness of Mexico's non-oil exports on world markets. Export growth was therefore held below potential while relatively inexpensive imports flooded the country.

The bubble burst early this year. Holders of pesos and peso-denominated financial assets recognized that recent balance-of-payments trends were not sustainable. Accordingly, the flight to hard-currency assets to avoid an imminent devaluation promptly drained the country's international-reserve cushion, thus precipitating the current crisis.

The financial crisis in Mexico is undoubtedly a temporary one. A country, unlike a company, cannot seek protection from the bankruptcy courts. However, a painful economic adjustment for the country lies ahead, and there is little doubt that an increased rate of business failures in the country will have some impact on foreign creditors.

The lesson again taught is that failure to analyze country risk in a cross-border transaction can be just as disastrous as failure to analyze the creditworthiness of an individual customer.

Dr. Richard S. Smith
Vice President and Director of
International Economics

Northwestern National Bank of Minneapolis
Seventh & Marquette
Minneapolis, Minnesota 55479

Indicators is a publication of Northwestern National Bank of Minneapolis Economics Department. For further information contact Dr. Sung Won Son, Senior Vice President and Chief Economist, (612) 372-7871; Dr. Richard Smith, Vice President, Director of International Economics, (612) 372-5845; Dr. Larry J. Wipf, Vice President, Director of Regional Economics, (612) 372-9281; or Janet Grant, Communications Officer, Corporate Communications, (612) 372-6704.